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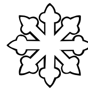

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TREATIES

Friday, September 24, 2004

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS,
WASHINGTON, DC.

The committee met at 9:34 a.m., in room SD–419, Dirksen Senate Office Building, Hon. Richard G. Lugar, Chairman of the committee, presiding.

Present: Senator Lugar.

OPENING STATEMENT OF HON. RICHARD G. LUGAR, U.S. SENATOR FROM INDIANA

The CHAIRMAN. This hearing of the Senate Foreign Relations Committee is called to order.

It is a pleasure to welcome our witnesses this morning and our distinguished guests to this hearing on the protocols amending the existing tax treaties with the Netherlands and Barbados.

As chairman of the Senate Foreign Relations Committee, I am committed to moving tax treaties as expeditiously as possible. Last year this committee and the full Senate approved treaties with Mexico, Australia, and the United Kingdom. Earlier this year, we finalized treaties with Japan and Sri Lanka. I have encouraged the administration to continue its successful pursuit of treaties that strengthen the American economy by providing incentives for foreign companies to expand their operations and, as a result, to create many more jobs right here in the United States. I also encouraged the administration to transmit tax treaties to the Senate on a timely basis for consideration so that the benefits may be fully realized, and today's hearing comes as a climax for two very important treaties that really fulfill those hopes.

The protocols that we have before us will bolster the economic relationships between the United States and countries that are already good friends and important trade and investment partners. As the United States considers how to create jobs and maintain economic growth, it is important that we try to eliminate impediments that prevent our companies from fully accessing international markets. These impediment may come in the form of regulatory barriers, taxes, tariffs, or unfair treatment. In the case of taxes, we should work to ensure that companies pay their fair share, while not being unfairly taxed twice on the same revenue. Tax treaties are intended to prevent double taxation so that companies are not inhibited from doing business overseas.

The existing tax treaty between the United States and the Netherlands was signed in 1992. The protocol before us today, which

amends that treaty, was signed on March 8 of this year, and we received it from the administration on July 16. It includes several novel provisions designed to prevent the inappropriate use of treaty benefits by those who are not legitimate residents or entities of either country. The administration has indicated that these anti-treaty-shopping provisions will now serve as a model as new tax treaties are negotiated. The protocol before us also makes many improvements to the existing treaty, including solidifying provisions regarding information exchange between the United States and Dutch taxing authorities.

As our Government endeavors to facilitate economic growth and to expand employment, international tax policies that promote foreign direct investment in the United States, such as this protocol, are really critically important. The Netherlands is the third largest foreign investor in the United States, with $155 billion in 2002. The Netherlands is a significant importer of United States goods and services, with imports of $18.3 billion in 2002. In fact, the United States has been running a trade surplus with the Netherlands of about $8.5 billion per year. Meanwhile, more than 1,600 United States companies have a presence in the Netherlands, employing more than 150,000 people. Now, this protocol will strengthen the important relationship between the United States and the Netherlands and improve the competitiveness of both countries.

The existing tax treaty with Barbados was signed in 1984. The protocol before us today was signed on July 14 of this year, and the primary objective of the protocol is updating the anti-treaty-shopping provisions and other elements that currently permit inappropriate exploitation of the treaty by companies that establish locations in Barbados simply to reap tax benefits. Thus, it closes a loophole that can shift economic benefits outside the United States, and this is important to both American workers and taxpayers.

The United States is the leading trading partner of Barbados. In 2002, the United States exported $425 million in goods and services to Barbados. This represents 40 percent of Barbados' total imports. Barbados provides the United States investors with special incentive packages pertaining to the hotel, manufacturing, and business service industries, among others. Many of these incentives are the result of benefits conferred through the tax treaty.

I am pleased especially to welcome our distinguished witnesses. On our first panel, we will hear from the chief negotiator of the protocols before us, Ms. Barbara Angus, the International Tax Counsel from the Department of the Treasury. Also on our first panel is Mr. George Yin, Chief of Staff to the Senate Joint Committee on Taxation. On our second panel, we will hear from witnesses representing the private sector. Mr. Bill Reinsch is President of the National Foreign Trade Council and Ms. Judy Zelisko is President of the Tax Executives Institute.

The committee looks forward to the insights and analysis of our expert witnesses. I would like for you to proceed now, and I will ask for you to testify first, Ms. Angus. Let me say to both witnesses and both panels all of your statements will be published in full in the record so you need not ask that that be done. Proceed as you wish, either with the full statement or a summary. We are delighted to have you and please proceed.

STATEMENT OF BARBARA ANGUS, INTERNATIONAL TAX COUNSEL, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Ms. ANGUS. Thank you, Mr. Chairman. I appreciate the opportunity to appear today at this hearing to recommend, on behalf of the administration, favorable action on income tax agreements with the Netherlands and Barbados. We appreciate the committee's interest in these agreements and in the U.S. tax treaty network, as demonstrated by the scheduling of this hearing.

We are committed to eliminating unnecessary barriers to cross-border trade and investment. The primary means for eliminating tax barriers are bilateral tax treaties. Tax treaties provide benefits to taxpayers and governments by setting out clear ground rules that will govern tax matters relating to trade and investment. A tax treaty is intended to mesh the two tax systems so that taxpayers do not end up caught in the middle of a dispute between two governments, both trying to tax the same income.

Coupled with the goal of removing tax barriers that can discourage cross-border investment and distort investment structures and locations is the need to ensure that our treaties cannot be used inappropriately, as such inappropriate use also can distort investment choices. We monitor our network of treaties to make sure that each treaty continues to serve its intended purposes optimally and is not being exploited for unintended purposes. Both in setting our overall negotiation priorities and in negotiating individual agreements, our focus is on ensuring that our treaty network fulfills its goals of facilitating cross-border trade and investment and preventing fiscal evasion.

We believe these agreements with the Netherlands and Barbados will serve to further the goals of our tax treaty network. Both of these agreements substantially improve longstanding treaty relationships.

I would like to highlight a key element that is common to the two agreements. Each agreement reflects significant developments with respect to the limitation on benefits provision designed to ensure that the benefits of the treaties are appropriately directed. The U.S. commitment to including comprehensive limitation on benefits provisions designed to prevent treaty shopping in all our treaties is one of the keys to improving our treaty network. Our treaties are intended to provide benefits to residents of the U.S. and residents of the particular treaty partner on a reciprocal basis. The treaty's benefits are not intended to flow to residents of a third country. If third country residents are able to exploit one of our treaties to secure reductions in U.S. tax, the benefits would flow in only one direction. Preventing this exploitation of our treaties is critical to ensuring that the third country will sit down at the table with us to negotiate on a reciprocal basis so that we can secure for U.S. persons reductions in tax on their investments in that country.

The anti-treaty-shopping approach used in U.S. treaties relies primarily on a series of objective tests rather than requiring an examination of motives. Of course, there is no one-size-fits-all objective test that covers all circumstances. Therefore, limitation on benefits provisions include a series of alternative tests, some common

across treaties and others tailored to particular circumstances. These objective tests have been refined over the years as more experience has been gained in applying and administering the tests and as the cross-border business structures subject to the tests have evolved.

The agreements with the Netherlands and Barbados reflect revisions to the limitation on benefits articles in the two treaties to modernize those rules. The agreements also reflect the reworking of one of the objective tests that has become a standard feature of our limitation on benefits provisions: the publicly traded company test.

The protocol with Barbados was negotiated in order to prevent the potential for exploitation of the treaty by U.S. corporations to facilitate inappropriate U.S. tax reductions. In recent years, a small number of U.S. corporations have engaged in corporate inversion transactions which involve a complicated restructuring in which a new foreign corporation is interposed between the public shareholders and the existing U.S. parent. This restructuring can be used to reduce U.S. tax on income from the corporate group's U.S. operations and also to reduce U.S. tax on income from any foreign operations of the group. In some corporate inversions, the new foreign parent claimed to be a resident of Barbados so that the provisions of the U.S.-Barbados treaty could be used to reduce U.S. tax on payments out of the existing U.S. corporate group. The use of the treaty in connection with this sort of corporate inversion transaction is neither intended nor appropriate.

The protocol with Barbados prevents this inappropriate exploitation of the treaty through modifications to the limitation on benefits provision. In particular, the protocol tightens the publicly traded company test to ensure that a company resident in Barbados must have a real nexus with Barbados in order to be eligible with the treaty benefits. With the protocol's changes, a Barbados company that is largely traded on a U.S. stock exchange, which is true of the corporations that have undertaken corporate inversions, will no longer qualify for treaty benefits.

The protocol with the Netherlands includes a more complete overhaul of the limitation on benefits provision in the current U.S.-Netherlands treaty.

The protocol with the Netherlands also reflects a new approach for the publicly traded company test designed to ensure the intended nexus between a public company and its country of residence, while recognizing the integration of the global financial markets. Under the protocol, a public company that does not have sufficient nexus to its residence country through trading on local stock exchanges must establish nexus through primary management or control there. Given developments in trading patterns, the new test better serves the intended purpose of limiting treaty shopping by third country residents. Moreover, the revisions were intended to be forward looking to prevent any potential for the U.S.-Netherlands treaty to be exploited by what really is a U.S. company in some future possible evolution of corporate inversion transactions.

In sum, the refinements to the limitation on benefits provisions in these two agreements reflect a common goal to ensure that the provisions serve its underlying objectives of limiting treaty benefits

to bona fide residents of the two treaty countries, while at the same time recognizing the need for certainty and clear, administrable rules.

Let me turn briefly to other highlights of these agreements.

The protocol with the Netherlands modifies the current treaty which entered into force in '93. In addition to the inclusion of the state-of-the-art anti-treaty-shopping provisions, the protocol with the Netherlands provides for the elimination of source company withholding taxes on dividends received by a company from an 80 percent owned subsidiary. We believe this provision is appropriate in light of our overall treaty policy of reducing tax barriers to cross-border investment and in the context of this treaty relationship which does include both comprehensive anti-treaty-shopping provisions and model exchange of information provisions. The elimination of source country withholding taxes on inter- company dividends provides reciprocal benefits because the Netherlands and the U.S. both have dividend withholding taxes and there are substantial dividend flows going in both directions.

The protocol further coordinates the two countries' rules regarding pension plans which will allow individuals to take up employment opportunities in either country without concerns about unintended tax effects on their retirement benefits.

And the protocol includes an update of the exchange of information provisions in the current treaty that fully reflects model standards in this area.

The protocol with Barbados was negotiated to ensure that the U.S.-Barbados tax treaty cannot be used inappropriately to secure tax reductions in circumstances where there is no risk of double taxation.

In addition to the changes to prevent exploitation of the treaty in connection with corporate inversions, the protocol adds a substantial further restriction in the case of entities that qualify for one of several special preferential tax regimes in Barbados. Under the protocol, the provisions of the treaty that provide for reductions in U.S. withholding taxes do not apply in the case of entities that are not subject to the generally applicable Barbados tax system and that benefit instead from a preferential regime. An entity that is subject to no or low taxation in Barbados under these preferential regimes does not have any real risk of double taxation that these treaty provisions are intended to address.

We urge the committee to take prompt and favorable action on the agreements before you today. Such action will further strengthen the U.S. tax treaty network by eliminating weaknesses and ensuring that our treaties continue to serve their intended purposes of facilitating real cross-border trade and investment.

Let me conclude by expressing our appreciation for the hard work of the staffs of this committee and the Joint Committee on Taxation in the tax treaty process. I would be happy to answer any questions. Thank you.

[The prepared statement of Ms. Angus follows:]

PREPARED STATEMENT OF BARBARA M. ANGUS, INTERNATIONAL TAX COUNSEL, UNITED STATES DEPARTMENT OF THE TREASURY

Mr. Chairman and distinguished Members of the committee, I appreciate the opportunity to appear today at this hearing to recommend, on behalf of the administration, favorable action on two income tax agreements that are pending before this committee. We appreciate the committee's interest in these agreements and.in the U.S. tax treaty network, as demonstrated by the scheduling of this hearing.

This administration is dedicated to eliminating unnecessary barriers to cross-border trade and investment. The primary means for eliminating tax barriers to trade and investment are bilateral tax treaties. Tax treaties eliminate barriers by providing greater certainty to taxpayers regarding their potential liability to tax in the foreign jurisdiction; by allocating taxing rights between the two jurisdictions so that the taxpayer is not subject to double taxation; by reducing the risk of excessive taxation that may arise because of high gross-basis withholding taxes; and by ensuring that taxpayers will not be subject to discriminatory taxation in the foreign jurisdiction. The international network of over 2000 bilateral tax treaties has established a stable framework that allows international trade and investment to flourish. The success of this framework is evidenced by the fact that countless cross-border transactions, from investments in a few shares of a foreign company by an individual to multi-billion dollar purchases of operating companies in a foreign country, take place each year, with only a relatively few disputes regarding the—allocation of tax revenues between governments.

Coupled with the goal of removing tax barriers that can discourage cross-border investment and distort investment structures and locations is the need to ensure that our tax treaties cannot be used inappropriately, as such inappropriate use also can distort investment choices. We continually monitor our existing network of tax treaties to make sure that each treaty continues to serve its intended purposes optimally and is not being exploited for unintended purposes. A tax treaty reflects a balance of benefits that is struck when the treaty is negotiated and that can be affected by future developments. In some cases, changes in law or policy in one or both of thetreaty partners may make it possible to increase the benefits provided by the treaty; in these cases, negotiation of a new or revised agreement may be very beneficial. In other cases, developments in one or both countries, or international developments more generally, may require a revisiting of the agreement to prevent exploitation and eliminate unintended and inappropriate consequences; in these cases, it may be necessary to modify or even terminate the agreement. Both in setting our overall negotiation priorities and in negotiating individual agreements, our focus is on ensuring that our tax treaty network fulfills its goals of facilitating cross border trade and investment and preventing fiscal evasion.

The administration believes that these agreements with the Netherlands and Barbados will serve to further the goals of our tax treaty network. Both of these agreements substantially improve long-standing treaty relationships. We urge the committee and the Senate to take prompt and favorable action on both agreements.

PURPOSES AND BENEFITS OF TAX TREATIES

Tax treaties provide benefits to both taxpayers and governments by setting out clear ground rules that will govern tax matters relating to trade and investment between the two countries. A tax treaty is intended to mesh the tax systems of the two countries in such a way that there is little potential for dispute regarding the amount of tax that should be paid to each country. The goal is to ensure that taxpayers do not end up caught in the middle between two governments, each of which claims taxing jurisdiction over the same income. A treaty with clear rules addressing the most likely areas of disagreement minimizes the time the two governments (and. taxpayers) spend in resolving individual disputes.

One of the primary functions of tax treaties is to provide certainty to taxpayers regarding the threshold question with respect to international taxation: whether the taxpayer's cross-border activities will subject it to taxation by two or more countries. Treaties answer this question by establishing the minimum level of economic activity that must be engaged in within a country by a resident of the other country before the first country may tax any resulting business profits. In general terms, tax treaties provide that if the branch operations in a foreign country have sufficient substance and continuity, the country where those activities occur will have primary (but not exclusive) jurisdiction to tax. In other cases, where the operations in the foreign country are relatively minor, the home country retains the sole jurisdiction to tax its residents.

Tax treaties protect taxpayers from potential double taxation through the allocation of taxing rights between the two countries, This allocation takes several forms.

First, the treaty has a mechanism for resolving the issue of residence in the case of a taxpayer that otherwise would be considered to be a resident of both countries. Second, with respect to each category of income, the treaty assigns the "primary" right to tax to one country, usually (but not always) the country in which the income arises (the "source" country), and the "residual" right to tax to the other country, usually (but not always) the country of residence of the taxpayer. Third, the treaty provides rules for determining which country will be treated as the source country for each category of income. Finally, the treaty provides rules limiting the amount of tax that the source country can impose on each category of income and establishes the obligation of the residence country to eliminate double taxation that otherwise would arise from the exercise of concurrent taxing jurisdiction by the two countries.

As a complement to these substantive rules regarding allocation of taxing rights, tax treaties provide a mechanism for dealing with disputes or questions of application that arise after the treaty enters into force. In such cases, designated tax authorities of the two governments—known as the "competent authorities" in tax treaty parlance—are to consult and reach an agreement under which the taxpayer's income is allocated between the two taxing jurisdictions on a consistent basis, thereby preventing the double taxation that might otherwise result. The U.S. competent authority under our tax treaties is the Secretary of the Treasury. That function has been delegated to the Director, International (LMSB) of the Internal Revenue Service.

In addition to reducing potential double taxation, treaties also reduce potential "excessive" taxation by reducing withholding taxes that are imposed at source. Under U.S. domestic law, payments to non-U.S. persons of dividends and royalties as well as certain payments of interest are subject to withholding tax equal to 30 percent of the gross amount paid. Most of our trading partners impose similar levels of withholding tax on these types of income. This tax is imposed on a gross, rather than net, amount. Because the withholding tax does not take into account expenses incurred in generating the income, the taxpayer that bears the burden of withholding tax frequently will be subject to an effective rate of tax that is significantly higher than the tax rate that would be applicable to net income in either the source or residence country. The taxpayer may be viewed, therefore, as suffering "excessive" taxation. Tax treaties alleviate this burden by setting maximum levels for the withholding tax that the treaty partners may impose on these types of income or by providing for exclusive residence-country taxation of such income through the elimination of source-country withholding tax. Because of the excessive taxation that withholding taxes can represent, the United States seeks to include in tax treaties provisions that substantially reduce or eliminate source-country withholding taxes.

Tax treaties also include provisions intended to ensure that cross-border investors do not suffer discrimination in the application of the tax laws of the other country. This is similar to a basic investor protection provided in other types of agreements, but the non-discrimination provisions of tax treaties are specifically tailored to tax matters and therefore are the most effective means of addressing potential discrimination in the tax context. The relevant tax treaty provisions provide guidance about what "national treatment" means in the tax context by explicitly prohibiting types of discriminatory measures that once were common in some tax systems. At the same time, tax treaties clarify the manner in which possible discrimination is to be tested in the tax context. Particular rules are needed here, for example, to reflect the fact that foreign persons that are subject to tax in the host country only on certain income may not be in the same position as domestic taxpayers that may be subject to tax in such country on all their income.

In addition to these core provisions, tax treaties include provisions dealing with more specialized situations, such as rules coordinating the pension rules of the tax systems of the two countries or addressing the treatment of Social Security benefits and alimony and child support payments in the cross-border context. These provisions are becoming increasingly important as the number of individuals who move between countries or otherwise are engaged in cross-border activities increases. While these matters may not involve substantial tax revenue from the perspective of the two governments, rules providing clear and appropriate treatment are very important to the individual taxpayers who are affected.

Tax treaties also include provisions related to tax administration. A key element of U.S. tax treaties is the provision addressing the exchange of information between the tax authorities.

Under tax treaties, the competent authority of one country may request from the other competent authority such information as may be relevant for the proper administration of the country's tax laws; the requested information will be provided

subject to strict protections on the confidentiality of taxpayer information. Because access to information from other countries is critically important to the full and fair enforcement of the U.S. tax laws, information exchange is a priority for the United States in its tax treaty program. If a country has bank secrecy rules that would operate to prevent or seriously inhibit the appropriate exchange of information under a tax treaty, we will not conclude a treaty with that country. Indeed, the need for appropriate information exchange provisions is one of the treaty matters that we consider non-negotiable.

TAX TREATY NEGOTIATING PRIORITIES AND PROCESS

The United States has a network of 57 bilateral income tax treaties covering 65 countries. This network includes all 29 of our fellow members of the OECD and covers the vast majority of foreign trade and investment of U.S. businesses. The primary constraint on the size of our tax treaty network may be the complexity of the negotiations themselves. The various functions performed by tax treaties, and most particularly the need to mesh the particular tax systems of the two treaty partners, make the negotiation process exacting and time-consuming.

A country's tax policy reflects the sovereign choices made by that country. Numerous features of the treaty partner's particular tax legislation and its interaction with U.S. domestic tax rules must be considered in negotiating an appropriate treaty. Examples include whether the country eliminates double taxation through an exemption system or a credit system, the country's treatment of partnerships and other transparent entities; and how the country taxes contributions to pension funds, earnings of the funds, and distributions from the funds, A treaty negotiation must take into account all of these and many other aspects of the particular treaty partner's tax system in order to arrive at an agreement that accomplishes the United States' tax treaty objectives.

A country's fundamental tax policy choices are reflected not only in its tax legislation but also in its tax treaty positions. The choices in this regard can and do differ significantly from country to country, with substantial variation even across countries that seem to have quite similar economic profiles. A treaty negotiation also must reconcile differences between the particular treaty partner's preferred treaty positions and those of the United States.

Obtaining the agreement of our treaty partners on provisions of importance to the United States sometimes requires other concessions on our part. Similarly, the other country sometimes must make concessions to obtain our agreement on matters that are critical to it. In most cases, the process of give-and-take produces a document that is the best tax treaty that is possible with that other country. In other cases, we may reach a point where it is clear that it will not be possible to reach an acceptable agreement. In those cases, we simply stop negotiating with the understanding that negotiations might restart if circumstances change. Each treaty that we present to the Senate represents not only the best deal that we believe we can achieve with the particular country, but also constitutes an agreement that we believe is in the best interests of the United States.

In some situations, the right result may be no tax treaty at all or may be a substantially curtailed form of tax agreement. With some countries a tax treaty may not be appropriate because of the regional markets, companies that are listed on a stock exchange in their home country nevertheless may have a substantial portion of their trading volume occur on another exchange in their region. Moreover, the international prominence of the U.S. stock exchanges means that many foreign companies are listed and substantially traded on U.S. exchanges. The fact that the publicly-traded company test has been structured to take into account both home-country trading and also U.S. and regional third-country trading reflects the realities of modern global financial markets. However, it has become clear that, in some circumstances, this test alone may not be sufficient to establish the nexus between the company and its country of residence that is the underlying objective of the limitations on benefits provision.

The proposed Protocol with Barbados was negotiated in order to prevent the potential for exploitation of the U.S.-Barbados treaty by U.S. corporations to facilitate inappropriate U.S. tax reductions. In recent years, a small number of U.S. corporations have engaged in corporate inversion transactions, which involve a complicated restructuring in which a new foreign corporation is interposed between the public shareholders and the existing U.S. parent corporation. This restructuring can be used to take advantage of U.S. tax rules to reduce U.S. tax on income from the corporate group's U.S. operations and also to reduce U.S. tax on income from any foreign operations of the corporate group. In some corporate inversion transactions, the new foreign "parent" corporation claimed to be a resident of Barbados so that the

provisions of the U.S.-Barbados treaty could be used to reduce U.S. tax on payments from the existing U.S. corporate group to the new Barbados company. The use of the treaty in connection with this sort of corporate inversion transaction was neither intended nor appropriate. More generally, the treaty was not intended to be used by companies that while technically resident in Barbados do not have sufficient nexus with Barbados.

The proposed Protocol with Barbados prevents this inappropriate exploitation of the treaty through modifications to the limitation on benefits provision. In particular, the proposed Protocol tightens the publicly-traded company test to ensure that a company resident in Barbados must have a real nexus with Barbados in order to be eligible for treaty benefits. This nexus is established through the requirement that the company's stock not only be listed on the Barbados stock exchange but also be primarily traded on the Barbados stock exchange (or on the sister exchanges in Jamaica or Trinidad and Tobago). As a result of the proposed Protocol's changes to the limitation on benefits provision, a Barbados company that is largely traded on a U.S. stock exchange, which is true of the corporations that have undertaken corporate inversion transactions, will no longer qualify for treaty benefits.

The proposed Protocol with the Netherlands includes a more complete overhaul of the limitation on benefits provision in the current U.S.-Netherlands treaty. It is notable that the current U.S.-Netherlands treaty broke new ground in terms of comprehensive anti-treaty-shopping rules and the inclusion of the provision in that treaty was crucial to our success in negotiating such provisions with other countries. The refinements included in the proposed Protocol reflect experience gained both through the administration of the provision in the current treaty and through the crafting of similar provisions in more recent treaties.

The proposed Protocol with the Netherlands also reflects a new approach for the publicly-traded company test designed to ensure the intended nexus between a publicly-traded company and its country of residence while recognizing the integration of the .global financial markets. With this new approach, a public company that does not have sufficient nexus to its residence country through trading on the stock exchanges in that country must establish nexus through primary management and control in its residence country in order to qualify for treaty benefits under the publicly-traded company test. Thus, for example, a Dutch company that has more trading on U.S. stock exchanges than on exchanges in the Netherlands and its economic region or that otherwise is overwhelmingly traded on exchanges outside the Netherlands will qualify for U.S. treaty benefits under this new test if the company's center of management and control is in the Netherlands (which establishes a real link between the company and the Netherlands). Given developments in trading patterns, the new publicly traded company test better serves the intended purpose of limiting treaty shopping by third-country residents. Moreover, the revisions to the test were intended to be forward looking, to prevent any potential for the U.S.-Netherlands treaty to be exploited by what is really a U.S. company in some possible future evolution of corporate inversion type transactions.

In sum, the refinements to the limitation on benefits provisions generally, and the publicly-traded company test in particular, that are included in the two pending agreements reflect a common goal: to ensure that the limitation on benefits provision serves its underlying objective of limiting treaty benefits to bona fide residents of our treaty partners. The specific approaches used in the two agreements to achieve this common' goal differ. As with many aspects of our limitation on benefits provisions, the differences are due to the differing economic and legal circumstances of the two treaty partners.

We intend to continue to scrutinize the limitation on benefits provisions in all our tax treaties. In addition to our ongoing efforts to incorporate such provisions in the few remaining U.S. treaties that do .not yet include them, we also will continue to review our limitation on benefits provisions generally, and the publicly-traded company test in particular, to make sure that the rules work to establish the intended nexus in the particular circumstances. If we find inadequacies in any of our treaties, we will work to refine the provisions in those treaties. As in the case of these two agreements, the optimal approach may well vary from treaty to treaty depending on the particular circumstances; flexibility in approach will be needed in order to accomplish the underlying objective while recognizing the need for certainty and clear, administrable rules.

DISCUSSION OF PROPOSED NEW TREATIES AND PROTOCOLS

I now would like to discuss the two agreements that have been transmitted for the Senate's consideration. We have submitted Technical Explanations of each

agreement that contain detailed discussions of the provisions of each treaty and protocol. These Technical Explanations serve as an official guide to each agreement.

The Netherlands

The proposed Protocol with the Netherlands was signed in Washington on March 8, 2004. The proposed Protocol modifies the current U.S.-Netherlands treaty, which entered into force in 1993, to take into account developments over the last decade, including changes in each country's tax laws and tax treaty policies.

The proposed Protocol includes significant changes with respect to the limitation on benefits rules. Although the current treaty includes a comprehensive limitation on benefits article, the details of the rules differ from those in other U.S. tax treaties in some respects and the rules have proven somewhat cumbersome in application for both taxpayers and the governments. The proposed Protocol brings the limitation on benefits article into closer conformity with the provisions in more recent U.S. treaties, including most particularly the new treaty with the United Kingdom. At the same time, as discussed earlier, the proposed Protocol tightens the limitation on benefits rules applicable to publicly-traded companies to ensure real nexus between the company and its residence country, as evidenced either by trading in the company's stock on the stock exchanges of such country or by the company's being primarily managed and controlled there.

The proposed Protocol modifies the current treaty's provisions setting maximum rates for source-country withholding taxes on cross-border dividends by providing for exclusive residence-country tax on certain intercompany dividends. This provision of the proposed Protocol provides for the elimination of source-country withholding taxes on certain intercompany dividends where the dividend is received by a company that owns at least 80 percent of the voting stock of the company paying the dividend. In the case of other dividends, the proposed Protocol continues the current treaty's limits on source-country withholding taxes, with a maximum rate of 5 percent applicable to direct dividends (where the recipient of the dividends is a company that owns at least 10 percent of the company paying the dividends) and 15 percent otherwise. The dividend withholding tax provisions in the proposed Protocol closely follow the analogous provisions in the recent agreements with the United Kingdom, Australia and Mexico.

Treasury believes that this provision eliminating source-country withholding taxes on certain intercompany dividends is appropriate in light of our overall treaty policy of reducing tax barriers to cross-border investment and in the context of this important treaty relationship. As I have testified previously, the elimination of source-country taxation of dividends is something that is to be considered only on a case-by-case basis. It is not the U.S. model position because we do not believe that it is appropriate in every treaty. Consideration of such a provision in a treaty is appropriate only if the treaty contains anti-treaty-shopping rules and an information exchange provision that meet the highest standards. In addition to these prerequisites, the overall balance of the treaty must be considered.

These conditions and considerations all are met in the case of the proposed Protocol with the Netherlands. The proposed Protocol includes both comprehensive anti-treaty-shopping provisions and model exchange of information provisions. The United States and U.S. taxpayers benefit significantly from the dividend withholding tax provision. The elimination of source-country withholding taxes on intercompany dividends provides reciprocal benefits because the Netherlands and the United States both have dividend withholding taxes and there are substantial dividend flows going in both directions.

The proposed Protocol updates the provisions applicable to dividends paid by REITs (and comparable Dutch entities) to conform to current U.S. tax treaty policy. The proposed Protocol reflects the refinement of approach adopted in 1997, which is intended to prevent the use of these entities to obtain withholding rate reductions that would not otherwise be available while providing appropriate reductions in the case of portfolio investors in REITs.

The proposed Protocol includes provisions intended to coordinate the two countries' rules regarding earnings and accretions of pension plans and contributions to pension plans in cross-border situations. For example, the proposed Protocol provides that in the case of a U.S. citizen who contributes to a U.S. qualified pension plan while working in the United States and subsequently establishes residence in the Netherlands, the Netherlands will not impose tax on the earnings and accretions of the pension plan with respect to that individual until distributions are made from the plan. In addition, the proposed Protocol extends the reach of provisions regarding cross=border pension contributions that are included in the current treaty to cover situations where a U.S. citizen residing in the Netherlands makes contributions to a Dutch pension plan.

The proposed Protocol extends the provision in the current treaty which preserves the U.S. right to tax certain former citizens whose loss of citizenship had, as one of its principal purposes, the avoidance of tax to cover also certain former long-term residents whose loss of such status had, as one of its principal purposes, the avoidance of tax.

The proposed Protocol includes a provision, similar to that in the U.S. model treaty and other recent treaties, which is intended to coordinate each country's obligations in situations in which a taxation measure falls within both the nondiscrimination provisions of the treaty and the national treatment obligations of the General Agreement on Trade in Services. The proposed Protocol also includes several other administrative and technical modifications, including an update of the exchange of information provisions in the current treaty that fully reflects U.S. model standards in this area.

The Memorandum of Understanding accompanying the proposed Protocol provides additional explanations and guidance regarding the agreed interpretation of the current treaty and the proposed Protocol. The Memorandum of Understanding is an update of the understanding with respect to the current treaty and is intended to replace that document.

Barbados

The proposed Protocol with Barbados was signed in Washington on July 14, 2004. The proposed Protocol was negotiated to ensure that the U.S.-Barbados tax treaty cannot be used inappropriately to secure tax reductions in circumstances where there is no risk of double taxation. The proposed Protocol also updates the current treaty to reflect changes in U.S. tax law and to bring the treaty into closer conformity with current U.S. tax treaty policy.

The most significant provision in the proposed Protocol is the modification of the current treaty's limitation on benefits article. As discussed earlier, the proposed Protocol revises the limitation on benefits article, with a particular focus on the publicly-traded company test, to ensure that the article operates effectively to limit treaty benefits to bona fide residents. Under the proposed Protocol, a company that is a resident of Barbados qualifies for treaty benefits under the publicly-traded company test only if the stock of the company is primarily traded on the Barbados stock exchange (or on one of the sister exchanges in Jamaica or Trinidad and Tobago).

The proposed Protocol adds a further restriction to the limitation on benefits article to address the treatment of entities that qualify for one of several special preferential tax regimes in Barbados. Under the proposed Protocol, the provisions of the treaty that provide for reductions in U.S. withholding taxes do not apply in the case of entities that are not subject to the generally applicable Barbados tax system and that benefit instead from a preferential tax regime. An entity that is subject to no or very low taxation in Barbados under these preferential regimes does not have any real risk of the double taxation that these treaty provisions are intended to address.

The current treaty preserves the U.S. right to tax former citizens whose loss of citizenship had, as one of its principal purposes, the avoidance of tax. The proposed Protocol expands this right to include taxation of former long-term residents whose loss of such status had, as one of its principal purposes, the avoidance of tax. The proposed Protocol also includes a clarification of the operation of the treaty's provisions relating to tax information exchange consistent with U.S. model standards in this area.

TREATY PROGRAM PRIORITIES

We continue to maintain a very active calendar of tax treaty negotiations. We currently are in ongoing negotiations with Canada, Chile, Hungary, Iceland, Korea and Norway. In addition, we are beginning negotiations with Germany. We also have substantially completed work with Bangladesh and France, and look forward to the conclusion of these new agreements.

As I noted earlier, a key continuing priority is updating the few remaining U.S. tax treaties that provide for low withholding tax rates but do not include the limitation on benefits provisions needed to protect against the possibility of treaty shopping. Another continuing priority is entering into new tax treaties with the former Soviet republics that are still covered by the old U.S.S.R. treaty (which does not include an adequate exchange of information provision). We also are focused on continuing to expand our treaty network by entering into new tax treaty relationships with countries that have the potential to be important trading partners in the future.

Following up on our discussion earlier this year, we have begun work on an update to the U.S. model tax treaty to reflect our negotiating experiences since 1996.

We look forward to working with the staffs of the Senate Foreign Relations Committee and Joint Committee on Taxation on this project.

CONCLUSION

Let me conclude by again thanking the committee for its continuing interest in the tax treaty program, and the Members and staff for devoting time and attention to the review of these new agreements. We greatly appreciate the assistance and cooperation of the staffs of this committee and of the Joint Committee on Taxation in the tax treaty process.

We urge the committee to take prompt and favorable action on the agreements before you today. Such action will further strengthen the U.S. tax treaty network by eliminating weaknesses and ensuring that our treaties continue to serve their intended purpose of facilitating real cross-border trade and investment.

The CHAIRMAN. Well, thank you very much, Ms. Angus. I would just echo your final comment about the important staff work done by Democratic and Republican staff members of this committee and the Joint Tax Committee. These folks have really made a difference in terms of moving forward these treaties. They are complex. They deserve public scrutiny, which you and your Department give, but likewise in the checks and balances of our constitutional system, we are obligated to give to have confidence. So I appreciate that tribute to our staffs, as likewise your own diligent work in this area. It is good to have you before the committee again.

Likewise, Mr. Yin, good to see you again, and would you please proceed with your testimony.

STATEMENT OF GEORGE YIN, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Mr. YIN. Thank you very much, Mr. Chairman. It is my pleasure to present the testimony of the staff of the Joint Committee on Taxation concerning the proposed protocols with Barbados and the Netherlands, which amend the existing treaties with those two countries. I am just going to very briefly identify a few issues about which the committee may wish to inquire.

On the Barbados protocol, as Ms. Angus has said, the most significant change is the proposed substitution of a new limitation on benefits article that tightens the scope of the treaty's eligible beneficiaries. Use of the existing treaty by unintended beneficiaries has been a key element in some recent corporate inversion transactions, as Ms. Angus described. The joint committee staff believes that the proposed protocol should prove effective in curtailing this inappropriate use of the existing treaty. Nevertheless, there are three issues the committee might wish to raise with the Treasury Department in connection with this improvement.

First, by rendering the Barbados treaty less suitable for use in tax-motivated transactions, the proposed protocol may cause certain taxpayers to look for second-best treaties in the United States network that may be still suitable for a similar use. Are there any other treaties that concern the Treasury Department in this regard, and if so, what measures are being taken to address those concerns?

The second is the proposed protocol makes taxpayers that are subject to very favorable tax regimes in Barbados, such as the international business companies regime, ineligible for only certain benefits of the U.S.-Barbados treaty. A question the committee might want to ask is, is there a reason the Treasury Department

did not make such taxpayers ineligible for all treaty benefits, given that there is no risk of meaningful double taxation in that case?

Finally, as a result of the tax act that was passed by Congress last spring, as you know, dividends received by individual shareholders from domestic and certain foreign corporations are generally taxed at a 15 percent tax rate. Qualifying foreign corporations generally include those that are eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines is satisfactory and includes an exchange of information program. Consistent with the relevant legislative history, the Treasury Department has, up until now, not treated the Barbados treaty as a qualifying treaty. Once the modifications made by this protocol enter into force, does the Treasury Department intend to reverse that decision, and if they do, how will they treat companies that are taxed under favorable tax regimes in Barbados and that therefore are eligible for only certain benefits under the treaty?

Let me now turn to the Netherlands protocol. There are also three areas in which the committee may want to inquire.

First, the protocol reduces from 5 percent to 0 the withholding tax rate on cross-border dividends paid by one corporation to another that owns 80 percent or more of the stock of the dividend-paying corporation, provided certain conditions are met. Although this provision does not appear in the U.S. or OECD model treaties, it is an identical or similar provision included in recent U.S. treaties with the UK, Australia, Mexico, and Japan, as well as the EU's parent subsidiary directive, as well as many bilateral tax treaties to which the U.S. is not a party.

The Treasury Department has previously stated and states again today that it would not consider a zero-rate provision in the absence of strong anti-treaty-shopping and exchange of information provisions, and that is clearly a sensible position for the Treasury to take. The real question, however, is that assuming those strong provisions are in place, are there any cases where the Treasury would not be willing to negotiate a zero rate on direct dividends? And under what further circumstances would Treasury be willing to permit a zero rate even where ownership of the dividend- paying corporation falls below the 80 percent threshold, such as the over 50 percent threshold that Treasury negotiated in the recent Japan treaty?

Second, like the Barbados protocol, the Netherlands protocol also contains a new limitation on benefits provision which is designed to tighten the scope of the treaty's eligible beneficiaries. In general, as Ms. Angus has described, in order to qualify for treaty benefits, a public company will have to maintain a substantial presence in the residence country. A company must either have a sufficient amount of its stock traded in its primary economic zone or day-to-day management responsibility exercised in the country of residence. Does the Treasury Department consider this to be a model limitation on benefits provision, and if so, do they intend to amend the U.S. model treaty to reflect that intention?

More generally, concerning limitation on benefits provisions with a member country of the European Union, some have speculated that developments in the EU might call into question certain bilat-

eral arrangements between an EU country and a non-EU country such as tax treaty benefits that are subject to standard limitation on benefits clauses. Of course, EU bodies do not have the authority to require the United States to grant any treaty benefits that the U.S. has not specifically negotiated. However, in light of the importance of limitation on benefits provisions to U.S. treaty policy, the committee may wish to ask the Treasury Department for its views as to how the ongoing process of European integration might affect the operation and development of the U.S. network of bilateral tax treaties with EU member countries.

Finally, one other unique feature of the Netherlands treaty and protocol is that it generally precludes U.S. tax jurisdiction over former U.S. citizens or long-term residents who are Dutch nationals. Current U.S. tax law preserves such jurisdiction in cases where the loss of citizenship or the termination of residency had, as one of its principal purposes, the avoidance of U.S. income tax. The committee might want to ask the Treasury why it agreed to this provision.

One last point. The Treasury Department reiterates in its statement today the statement that it made before this committee back in February, that it plans to update the U.S. model treaty and to work with the staff of your committee, as well as our staff in doing so. The committee may wish to ask about the time table of this project.

I ask that the staff report that was prepared in conjunction with this hearing also be included in the record as well as the full testimony.

The CHAIRMAN. It will be included in full.

[The prepared statement of Mr. Yin and the Joint Committee on Taxation follows:]

TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS HEARING ON THE PROPOSED TAX PROTOCOLS WITH BARBADOS AND THE NETHERLANDS [1]

SEPTEMBER 24, 2004

My name is George Yin. I am Chief of Staff of the Joint Committee on Taxation. It is my pleasure to, present the testimony of the staff of the Joint Committee on Taxation today concerning the proposed income tax protocols with Barbados and the Netherlands.

OVERVIEW

As in the past, the Joint Committee staff has prepared pamphlets covering the proposed protocols. The pamphlets provide detailed descriptions of the proposed protocols, including comparisons with the 1996 U.S. model income tax treaty, which reflects preferred U.S. tax treaty policy, and with other recent U.S. tax treaties. The pamphlets also provide detailed discussions of issues raised by the proposed protocols. We consulted with the Treasury Department and with the staff of your committee in analyzing the proposed protocols and in preparing the pamphlets.

The proposed protocol with Barbados would amend an existing tax treaty that was signed in 1984 and was modified by a protocol signed in 1991. The proposed protocol with the Netherlands would update the existing treaty signed in 1992 and

[1] This document may be cited as follows: Joint Committee on Taxation, Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on the Proposed Tax Protocols with Barbados and the Netherlands (JCX–58–04), September 22, 2004.

modified by protocol in 1993. My testimony today will highlight some of the key features of the proposed protocols and certain issues that they raise.

BARBADOS

Elimination of certain inappropriate benefits available under the existing treaty

The most significant change made by the proposed protocol with Barbados is the replacement of the existing treaty's limitation-on-benefits article with a new article designed to eliminate certain inappropriate benefits that are available under the existing treaty. Specifically, the.existing treaty allows a company that is legally resident in Barbados to claim the benefits of reduced U.S. withholding tax rates by virtue of being publicly traded, even in cases in which the company has no meaningful economic presence in Barbados and is subject to only nominal levels of taxation there, under a special tax regime such as the "International Business Companies" regime. This aspect of the existing treaty has been a key element in some recent "corporate inversion" transactions that have been used by U.S.-based multinational enterprises to erode the U.S. tax base. The proposed protocol modifies the limitation-on-benefits provision of the existing treaty to eliminate inappropriate treaty benefits under these and similar circumstances, as explained in detail in our pamphlet.

The Joint Committee staff believes that the proposed protocol should prove effective in curtailing the inappropriate benefits that are available under the existing treaty. Thus, the proposed protocol should be viewed as a significant improvement by those concerned about the use of the existing treaty to facilitate tax-motivated transactions. Nevertheless, we have identified three issues that the committee might wish to raise with the Treasury Department in connection with the proposed protocol.

Potential availability of inappropriate benefits under other U.S. treaties

First, by rendering the Barbados treaty less suitable for use in tax-motivated transactions, the proposed protocol may cause certain taxpayers to look for "second-best" treaties in the U.S. network that may be suitable for similar use. The committee may wish to ask the Treasury Department whether it has concerns about any other U.S. tax treaties in this regard, and if so, what measures are being taken to address these concerns.

Treatment of special tax regimes outside the context of withholding taxes

Second, while the proposed protocol disallows treaty benefits in most situations in which the recipient of a payment is entitled to the benefits of a special tax regime, such as the Barbados "International Business Companies" regime, the proposed protocol leaves open the possibility that such a person may qualify for some benefits of the treaty under some circumstances, even though there is no risk of meaningful double taxation in such a case. Some may argue that it would have been best to foreclose entirely the possibility that persons that enjoy tax-haven-type benefits under the laws of a treaty country could qualify for treaty benefits.

Interaction with U.S. rate preference for dividend income

Third, under the Jobs and Growth Tax Relief Reconciliation Act of 2003, dividends received by an individual shareholder from domestic corporations are generally taxed at the preferential rates that apply to certain capital gains. Dividends received from a foreign corporation also may be eligible for this rate preference in some cases. One way in which a dividend from a foreign corporation may qualify is if the foreign corporation is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory for purposes of the rate-preference provision, and which includes an exchange of information program. Consistent with a statement made in the relevant legislative history, the Treasury Department announced in a notice that the existing treaty with Barbados is not satisfactory for purposes of the rate-preference provision. In that same notice, the Treasury Department indicated that the amendment or renegotiation of existing tax treaties may be a factor in deciding whether to amend its list of qualifying treaties. The committee may wish to ask the Treasury Department whether it intends to amend its list of qualifying treaties to include the U.S.-Barbados treaty, once the modifications made by the proposed protocol enter into force. In addition, if the Treasury Department does intend to add this treaty to the list of qualifying treaties, the committee may wish to ask how companies that are eligible for the benefits of a special tax regime will be treated for these purposes.

NETHERLANDS

The proposed protocol with the Netherlands modifies several important articles in the existing treaty; Many of the provisions of the proposed protocol are generally consistent with the U.S. model treaty; however, there are a few areas in which the committee may wish to inquire.

"Zero-rate" dividend provision

One area is the proposed "zero rate" of withholding tax on certain intercompany dividends. The provision would eliminate source-country tax on cross-border dividends paid by one corporation to another corporation that owns 80 percent or more of the stock of the dividend-paying corporation, provided that certain conditions are met. Under the current treaty with the Netherlands, these dividends may be subject to withholding tax in the source country at a rate of five percent. The proposed elimination of the withholding tax is intended to further reduce tax bathers to direct investment.

The principal immediate effects of the zero-rate provision on U.S. taxpayers and the U.S. fisc would be: (1) to relieve U.S. corporations of the burden of Dutch withholding taxes in connection with qualifying dividends received from Dutch subsidiaries; (2) to relieve the U.S. fisc of the requirement to allow foreign tax credits with respect to these dividends; and (3) to eliminate the withholding tax revenues currently collected by the U.S. fisc with respect to qualifying dividends received by Dutch corporations from U.S. subsidiaries.

This provision does not appear in the U.S. or OECD model treaties. However, many bilateral tax treaties to which the United States is not a party eliminate withholding taxes in similar circumstances. The European Union has also eliminated withholding taxes in similar circumstances under its "Parent Subsidiary Directive." In 2003, the Senate approved adding zero-rate provisions to the U.S. treaties with the United Kingdom, Australia, and Mexico, and earlier this year the Senate approved adding a zero-rate provision to the U.S. treaty with Japan. Those provisions are similar to the provision in the proposed protocol.

The committee may wish to determine whether the inclusion of the zero-rate provision in the proposed protocol signals a broader shift in U.S. tax treaty policy. The committee also may wish to consider whether and under what circumstances the Treasury Department intends to pursue similar provisions in other treaties and whether the U.S. model will be updated to reflect these developments. In addition, the committee may wish to inquire further, as to the rationale for the October 1, 1998 stock ownership testing date with respect to eligibility for the zero rate on dividends received by companies that satisfy the limitation-on-benefits provision only under certain specific tests contained in that provision. While this limitation on the zero rate for direct dividends apparently is modeled after a similar limitation in the U.S.-UK treaty, it is unclear why the October 1, 1998 testing date that applies for purposes of the U.S.-UK treaty is relevant in the context of the proposed Netherlands protocol.

Anti-treaty-shopping provision

The limitation-on-benefits provision in the proposed protocol is similar to the anti-treaty-shopping provisions in several recent U.S. income. tax treaties; however, the anti-treaty-shopping provisions in the proposed protocol include a new requirement that tests for "substantial presence" in the residence country in order for a public company to qualify for treaty benefits.

Under the U.S. model and more recent U.S. income tax treaties, a public company can qualify for treaty benefits if it is listed in one of the two treaty countries and regularly traded on a recognized stock exchange, thereby allowing a company to qualify for treaty benefits if all the trading takes place in the other country or a third country exchange. Under the proposed protocol, a company must establish substantial presence in the residence country in order to obtain treaty benefits. A company must establish substantial presence by meeting one of two requirements.

The first requirement determines whether public trading constitutes an adequate connection to the residence country. To establish adequate connection, the stock of the company must have a greater volume of trading in its primary economic zone than in the other treaty country and at least 10 percent of its worldwide trading must occur within its primary economic zone. For the United States, the primary economic zone includes all NAFTA countries and for the Netherlands, the primary economic zone includes the European Economic Area and the European Union.

If a company fails the first requirement, it can still establish substantial presence if it meets the second requirement. The second requirement determines whether the company's primary place of management and control is in the country where it is a resident. This test should be distinguished from the "place of effective manage-

ment” test that is used by many countries to establish residence and by the OECD model as a tiebreaker. The primary place of management and control test under the proposed protocol looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised. This is based on where the executive officers and senior management employees exercise day-to-day hearing earlier this year, the Joint Committee staff believes that this model is becoming obsolete and is in need of an update. At that same hearing, the Treasury Department staled that it intended to update the model. The committee may wish to inquire of the Treasury Department as to the current status of this project.

I would be happy to answer any questions that the committee may have at this time or in the future.

Mr. YIN. Thank you very much. I would be happy to answer any questions, sir.

The CHAIRMAN. Well, thank you very much, Mr. Yin. You have raised a great number of questions that are important to consider. Some of these perhaps Ms. Angus may wish to respond to.

Let me begin the questioning by asking you a more general question. Ms. Angus, can you describe the general criteria used to determine what country is suitable for a tax treaty with the United States? And how have we determined in the past suitable candidates? Are those criteria changing? Are they becoming more stringent, more liberal, or can you give us some idea of how we get into this business?

Ms. ANGUS. Thank you, Mr. Chairman. We really look at a variety of things. The negotiation of a tax treaty is a fairly complicated process, so it requires a significant commitment of resources. That means that we necessarily have to prioritize potential tax treaties. In trying to set the priorities, the primary consideration is whether there are tax problems faced by investors in that country that can be corrected by a tax treaty. When those sorts of problems exist, potential double taxation, for example, because of the interaction of the two tax systems, or other ways in which the two tax systems interact to create a special impediment, we look at things like the extent of bilateral economic relations between the United States and that country and also the structure of the country’s tax system. Some tax systems are structured in a way that better lend themselves to coordination through a tax treaty; others create greater complexity.

It is important to note that in the case of the United States a tax treaty is an essential as the only means for eliminating double taxation because we have provisions in our domestic law that unilaterally address double taxation. However, there are double taxation issues that can arise between countries that are just the sort of thing that the tax treaties do address.

A tax treaty necessarily has to be an individualized agreement because it has to mesh the specifics of our tax system and our tax system as it evolves with the specifics of the other country’s tax system. So although I sometimes feel bad about saying this, because we are continually changing our own tax system, we do look to the stability of the tax system of the other country. If the other country is about to embark on a significant reform of their tax system, it may make more sense to wait instead of investing a lot of time in negotiating provisions that mesh the current system, but they will be out of date as soon as the system is reformed.

Another thing that we look to is whether we believe that the country is able to assume the obligations that it has to assume

under a tax treaty including, for example, its obligations and commitments with respect to exchange of information and with respect to the protection of the confidentiality of information. So it is a balancing.

We are always looking to further balance between our efforts to extend our treaty network, to establish new relations with countries where we have not previously had a tax treaty. Our treaty that entered into force this summer with Sri Lanka is an example of that. It is our first tax treaty relationship with that country, with the need to keep our existing treaties up to date, and the treaties before us, as well as the new treaty that entered into force earlier this year with Japan, are examples of that part of our priorities.

The CHAIRMAN. Well, certainly the treaty with Japan that we considered earlier in the year would fit the criteria of a country of extraordinarily important relationships. As we cited in our earlier testimony, the relationship with the Netherlands is very substantial, the third largest trading partner. So this fits certainly that criteria that you are up to date where a lot of the action is.

Let me just mention the distinguished Ambassador of the Netherlands is with us today. Would you stand, sir, so you can be recognized? We are delighted that you are here and honored that you would come to our hearing. I understand the Ambassador from Barbados may be under way. He is here. Great. We are delighted to have you.

Let me ask one of the questions that Mr. Yin raised which is intriguing, and that is, clearly with the Barbados treaty, we are attempting to correct a potential for tax evasion. But Mr. Yin correctly raises the question of having done the right thing vis-a-vis Barbados and the United States, what about other situations. Does this mean that those that have ulterior motives move on to some other weakness in the system? And if so, have you thought about that? Are we sort of pushing folks along the trail to do something unfortunate somewhere else?

Ms. ANGUS. That is exactly the issue and we have thought about it. The Barbados treaty is the one that was widely identified by tax planners as the path to use in a corporate inversion transaction. That is why we think it is critically important to shut down this inappropriate exploitation of the Barbados treaty and the protocol will do that.

But at the same time, you are exactly right. We have got to look at our other treaties to make sure that with the Barbados path closed off, other avenues do not become more attractive. Even where we do not see inversions happening, it still make sense to foreclose even what may be a remote possibility. One example in this regard is the changes to the limitation on benefits provision reflected in the Netherlands protocol. Those changes were intended to be very forward- looking, to ensure that the Netherlands treaty cannot sometime in the future somehow be exploited for some future evolution of this kind of transaction, and at the same time, the changes in that protocol are intended to recognize the realities of the global financial markets and are structured so as not to adversely affect real companies doing business between the U.S. and the Netherlands, the real intended beneficiaries of the treaty. We

have got to consider and will consider similar limitation on benefits changes in other treaties as appropriate.

We also continue to be focused on adding limitation on benefits provisions to those treaties in our network that do not have these important anti-treaty-shopping protections. And in this regard, we are in ongoing negotiations to update our treaties with Hungary and Iceland, two treaties that do not currently contain comprehensive limitation on benefits provisions.

The CHAIRMAN. Well, that is certainly reassuring.

Just as a practical matter, today we are taking up two treaties that have been in force for quite a while, and these are amendments or revisions to the treaties. It would occur to me, just logically from what you are suggesting, that there may be a who raft of treaties that need some treatment, not overall revision perhaps, but as you come upon these inequities and you find the possibility that somebody might be shopping treaties again.

Is there some way in a more wholesale fashion—and I am raising this without having the technical background to do so—that you can bring before the committee sort of a list of these situations so that in fact sort of as a generic class, we sort of fix all the treaties that may be relevant?

This is an interesting problem. There are a lot of very talented people in this country and around the world who I suspect look at this whole structure for weaknesses. And correspondingly, in the public interest, we are trying to make certain that there is fairness and, furthermore, confidence in the tax system.

Without getting into the rhetoric of the Senate floor, I would just say with regard to the Barbados treaty, a good number of Senators would raise the question, what is going on there with regard to fairness in taxation with ordinary Americans? Are some extraordinary pieces of tax evasion occurring here wholesale? And without answering whether they are or not, you are attempting to say we better make certain we have equity here. We are trying to make sure that there are not gaps in the system.

I would just be curious, Mr. Yin, about your judgment. How do we approach this situation that your question, which is very thoughtful, raises about treaty shopping or country shopping or so forth? What is a proper way as a technician as you have looked at this issue?

Mr. YIN. Thank you, Mr. Chairman.

Well, I think that certainly we would concur with Treasury's approach in addressing the Barbados treaty first because that did seem to be the one that was most in need of some remedy in this area.

Beyond that, I would suggest that, as the Treasury indicated, they are viewing the entire network of treaties. I think it would be useful to lay out, perhaps through their model treaty approach, perhaps different alternatives. They now have an interesting new proposal which, of course, they have proposed in the Netherlands protocol. Perhaps that will be a model for all future treaties or perhaps that does not work for certain ones and they might want to offer an alternative for countries in a different situation. But whatever their thinking is, it would seem that the more that they are laying out their thinking to the various stakeholders, as well as of

course to Congress for its oversight function, that would potentially be an advance in this area.

The CHAIRMAN. You raised another question, Mr. Yin, about this entire model treaty time table as to how that is going to progress. Ms. Angus, do you have any thoughts about that? What can you tell us about Treasury's activities with the model treaty time table?

Ms. ANGUS. We are actively working to update the model treaty. I think in particular with the entry into force in the last 2 years of comprehensive new tax treaties with two of our major partners, the UK and Japan—and those were both fundamental overhauls of those treaties—it seemed to us that now is a particularly good time to revisit the model, to reflect developments, to take into account our recent negotiating experiences, and I would add to that as well our experiences with respect to these two protocols and the need to look more closely at some of the limitation on benefits provisions. As I said, we are actively working on producing an update and we are hoping to have that work substantially complete by the end of the year.

We agree with the joint committee that having an updated model out there is very valuable to those that follow treaty matters closely. It gives a clear picture of what our negotiating priorities are, of what our policies are, and it is important to have that information out there.

At the same time, we do have to balance the work on updating the model with work on ongoing negotiations, both to update existing treaties and to establish new treaty relationships. Again, as I said, we are hoping to have the work on updating the model substantially complete by the end of the year.

The CHAIRMAN. Well, we appreciate that and I thank you for that testimony because that is very encouraging. Our committee, as you can perceive, has taken quite an interest in this general area. It is extremely complex and perhaps sometimes does not have the drama of our hearings on Iraq, North Korea, Iran, or other subjects, but at the same time, in terms of American business, workers, tax equity, and what have you, it is tremendously important in terms of the public good, which you would recognize, and this is why you serve as you do.

Let me just ask this question of you, Ms. Angus. In the Netherlands protocol specifically, there are changes to the provisions in the underlying treaty regarding worker pensions. Now, can you explain what impact these provisions will have on United States nationals working in the Netherlands?

Ms. ANGUS. The provisions are intended to improve worker mobility by better coordinating the two countries' rules on the treatment of pension contributions, earnings in pension funds, and then distributions received from pension funds so that individuals do not have to worry about unexpected foreign tax consequences or double tax consequences impacting what they have been intending to set aside for their retirement. The provisions in the protocol with the Netherlands build on provisions in the current treaty and are a significant improvement.

Focusing on U.S. persons working in the Netherlands, there are several important provisions in the protocol. Where a U.S. person was making contributions to a U.S. pension plan before moving to

the Netherlands to take a job there, the Netherlands will allow deductions for continuing contributions to that U.S. plan as if it were a Netherlands plan. Where a U.S. person that has an interest in a U.S. pension plan retires in the Netherlands, under the protocol the Netherlands will not impose tax on the earnings in the pension plan and will impose tax only when the retiree receives distributions, which is when the retiree was expecting to be subject to tax with respect to the pension.

Then there are also provisions dealing with the situation where a U.S. person living in the Netherlands participates in a Dutch pension plan. So, for example, a U.S. person who is employed not by a Dutch subsidiary of a U.S. company but by a Dutch company, so he or she is participating in a Dutch pension plan. In that situation, the protocol provides that the U.S. will allow deductions for U.S. tax purposes for contributions to that Dutch plan.

Provisions like this on cross-border pensions are becoming increasingly important as more and more individuals spend part of their career working in a different country or working in several different countries. So finding ways to coordinate the pension systems of two countries, such as we have done here, will become more and more important and a greater focus as we look to update some of our older treaties.

The CHAIRMAN. All of these items that you have given very explicitly substantially benefit or offer assurances to American employees who are involved in this. Sometimes changes are criticized because they adversely affect persons and change the whole rules of the game. In essence, you are offering assurance to American employees, whether they are working for Dutch firms, American firms, have a Dutch pension plan, an American one, maybe both, that the double taxation situation does not ensue and, in fact, certain deductions are recognized, which is a very sophisticated but very important point for a lot of Americans who may be involved in this.

Let me ask about the effect, for instance, of these so- called inversion problems that are trying to be cured in the Barbados treaty. What is the impact of this on the United States domestic economy? Why should Americans be concerned whether taxes are being paid or evaded or there is treaty shopping? What finally happens back here as a result of all of this business?

Ms. ANGUS. Well, a corporate inversion is a transaction that can be very complicated as a structural matter. Operationally it can be virtually transparent. The company can operate the same way the day before the transaction and the day after the transaction, but the transaction can be used to achieve a substantial reduction in taxes. And that sort of opportunity, a substantial reduction in taxes through a transaction that is complicated as a technical matter, but virtually transparent operationally, is a cause for concern as a policy matter.

These transactions can provide opportunities for inappropriate shifting of income from U.S. companies in the corporate group to outside the U.S. That represents an erosion of the U.S. corporate tax base. The transactions can mean a competitive advantage to companies that choose to undergo an inversion. That means a corresponding competitive disadvantage for their U.S. competitors

that chose not to invert and choose to continue to operate in a U.S.-based group. The possibility of these transactions and their exploitation of inappropriate opportunities for U.S. tax reductions as an overall matter can erode confidence in the fairness of the tax system.

The Barbados protocol helps ensure that these transactions cannot be used to avoid paying one's fair share of taxes, and shutting down the transactions helps to restore the competitive balance, eliminating the distortions that can be caused when complex corporate transactions can be used to dramatically change tax results.

As a bottom line, we want companies to continue to choose to be based in the United States. So we need to keep our focus in our treaty policy, in our tax policy, and elsewhere on the overarching goal of maintaining the attractiveness of the U.S. as the most desirable location in the world for incorporation, headquartering, foreign investment, business opportunities, and employment opportunities.

The CHAIRMAN. Yes, Mr. Yin?

Mr. YIN. I might just reiterate that a corporate inversion, really in general terms, would have two potential effects. One would be a reduction in the U.S. tax on foreign source earnings, and the other would be potentially a reduction of the U.S. tax on U.S. source earnings. I think that there are reasonable policy disagreements in terms of to what extent the U.S. should continue to tax foreign source earnings of U.S. taxpayers. Different Members of Congress certainly disagree on that point, but I think there is little or no disagreement on the point that the U.S. tax should certainly continue to apply in full to U.S. source earnings of companies. And to the extent an inversion transaction would allow companies to escape that tax burden, that clearly would be an object that should be curtailed.

The CHAIRMAN. Just in simple layman's terms, essentially you are saying activity, business, whatever occurs here in the United States of America, along with everybody's business here, it ought to be taxed in the same way, that there ought not to be ways in which all this activity occurs and has consequences, but suddenly it all disappears into some other country and no tax is paid. And in essence, this is clearly unfair. It is felt that way, I will tell you, out on the hustings. People become very angry about these issues and wonder why we in Government are unable to see what is going on and to bring about fairness. So you are striking a blow for fairness today. We hope to assist you.

Let me just ask one more question. This is a technical question Mr. Yin raised, Ms. Angus. But the Japan treaty that we ratified earlier in the year spoke to this question of the zero tax rate if 50 percent ownership of a company was involved. The Dutch tax treaty, as I recall, has an 80 percent criteria. Can you explain the difference? Should we be going to 50, 80, where? Or what do you have to say about this particular situation?

Ms. ANGUS. Well, the provision in the Dutch protocol closely mirrors the provision that was included in our new U.S.-UK tax treaty, and it provides for an elimination of dividend withholding taxes in case of a parent and subsidiary where there is an 80 percent ownership, significant identity of economic interests between the par-

ent and the subsidiary. That is a conservative approach to this provision. We think it is appropriate to approach this conservatively, as it is something that we have included only in a few U.S. treaties thus far.

There are particular benefits, in this case, of having a provision that is similar between the U.S. and UK treaty and the U.S. and the Netherlands treaty because there are several significant businesses that are operated through joint UK-Netherlands structures, and by having the provisions operate in the same way, there are administrative and technical advantages to that.

In the case of the treaty with Japan, we did provide for elimination of dividend withholding in a slightly broader range of cases in all situations where the dividend was paid to a parent that controlled the subsidiary, so it had a more than 50 percent ownership. That was a provision that was important to Japan. It was an ownership threshold that was significantly higher than the threshold that Japan used in its other treaties for a similar provision. On balance, given the significant changes that were included in the Japan treaty, most particularly the first time that Japan had ever agreed to eliminate withholding taxes on royalties, which was an issue of great importance to the U.S. business community, we thought it was appropriate to consider the broader provision in that case. It also recognized particular issues in the Japanese capital markets and in the ownership structures that are prevalent in Japan where there is a greater incidence of situations where you have got a company that has a substantial interest in a subsidiary but not an 80 percent interest.

And so it was a balancing in that treaty, and it is a balancing in this treaty as well. It is something that we think that we ought to continue to look at closely as we go forward.

The CHAIRMAN. Just as a matter of personal curiosity, Mr. Yin has mentioned a number of items. In fact, he asked about the time table for the model treaty, as well as things that might be provided in it. Is the joint committee regularly in touch with Treasury? In other words, as you think of things that ought to be a part of a model treaty, probably Treasury has thought of them too, maybe some of our staff. But I am just curious what the communication is. Is there a working relationship so that as this model treaty is moving on toward conclusion, the very best ideas are happening before they come to a hearing such as this one in which we ask, have you thought of this? Can either of you give any comment about your communications?

Ms. ANGUS. I could start by saying that we certainly value the opportunity to work closely with the joint committee. The joint committee staff's review of our treaties always is of benefit to us. They identify questions and raise issues that are very important for us to focus on, and they also help find solutions to those issues.

When I indicated that we hoped to have the model substantially complete by the end of the year, maybe I should have been clearer that as we go through that process, we want to have a first draft that we are in a position to be able to talk with the joint committee staff and get their thoughts on some of the harder questions.

We have also benefitted from the joint committee's analysis of these protocols and of the last several treaties and protocols where

they have, in their pamphlets and in their discussions with us, made particular note of deviations from the existing model and made a particular point of making sure that we were focused on whether this provision that was in a given treaty is one that ought to be in the model so that people know, going forward, that it is our policy, or is it one that was tailored to some particular circumstance and is not for the model. So, certainly we hope to be able to work very closely with the staffs as we go forward on the model.

Mr. YIN. Let me just echo that we certainly value very highly our relationship with the Treasury Department and we stand ready to assist the Treasury Department at whatever point it wishes to present a draft of a model treaty or really on any other treaty issues that might come to their attention.

The CHAIRMAN. Well, that is very reassuring. And then as you have your joint product, I know you will share it with our staff members on both sides of the aisle so that as we come to these hearings and potential action, we have all tried to think in advance of the hypotheticals and tried to resolve those as best we can.

Well, I appreciate very much the testimony of both of you today, and we look forward to continuing to work with you. The agenda is not yet complete as you have pointed out. You have more work for us to do, and hopefully early in the next session, we will be taking a look at perhaps the model treaty and/or other bilateral efforts that you have negotiated.

Do either of you have further comment that you have not had a chance to say?

Ms. ANGUS. I do not want to take up too much of the committee's time, but I would like, if you would not mind, to take just a minute to comment on a matter that the joint committee noted in its report on the Netherlands treaty.

The CHAIRMAN. Good.

Ms. ANGUS. And that was the speculation that some have engaged in regarding whether developments in the European Union in the years to come could have implications for tax treaty relationships between U.S. and EU member countries. There has been a fair amount of speculation about this recently, and I think there are a couple of important points to be made about it and I will be try to be quick about that.

I think first and foremost, no matter what happens in the EU, the U.S.'s ability to apply limitation on benefits provisions contained in our treaties will not be affected. Nothing that may occur in the EU can affect in any way the U.S.'s ability to apply this treaty, the Netherlands treaty, and all our other treaties in accordance with their terms.

More generally, it is important to reiterate that U.S. tax systems are intended to mesh the U.S. tax system with the particular tax system of the treaty partner, and tax treaties necessarily reflect a balancing of U.S. tax treaty policy with the tax treaty policy of the particular treaty partner. The EU does not now have a single tax system, and the EU also does not now have a single tax treaty policy. Indeed, there are significant variations in these areas across EU countries.

As long as EU countries have different tax systems, there will be a need to have different provisions in U.S. treaties with those countries in order to ensure that the treaty meshes the systems properly, and as long as EU countries have different tax treaty policies, there will be potential differences as the treaties reflect that balancing of our treaty policies with each other country's treaty preferences.

As long as there are those differences, we need to protect against treaty shopping. Some EU countries share the U.S. preference for reducing withholding taxes to the greatest extent possible. Other EU countries insist on relatively higher withholding taxes. That creates the potential for treaty shopping, and thus the need for our comprehensive limitation on benefits provisions.

To the extent that in the future there is more EU integration with respect to tax and treaty policy, the U.S. limitation on benefits provisions already contain the mechanism that will recognize this. To the extent that there is convergence that is reflected in comparable treaties across EU countries, the so-called derivative benefits rule that is contained in U.S. treaties means that U.S. treaty benefits will apply in the case of cross investment through another EU country because the investor would have been entitled to the same benefits under its own treaty with the U.S.

I guess just in sum, we believe that the treaty with the Netherlands, as improved by the proposed protocol, will well serve our two countries not only today but also as developments in the EU progress.

The CHAIRMAN. I appreciate that. That was an important question raised by Mr. Yin, and I thank you for that very comprehensive response.

Well, thanks to both of you and we will look forward to now our next panel, which will be the Honorable William Reinsch, President of the National Foreign Trade Council, and Ms. Judith Zelisko, the President of the Tax Executives Institute of Washington, D.C.

Let me mention as a point of personal privilege that, as I note the distinguished Netherlands delegation is leaving, one of the persons with us today was Casper Veldkamp who formerly served in my office, first as a student intern and then as a staff member. We are very proud that he is now serving the Netherlands on the staff as Dutch political counselor and was at the hearing today. It was great to have you, Casper, and we are proud of you.

Mr. VELDKAMP. Thank you, Senator. Some of our staff will stay here.

The CHAIRMAN. Great.

I would like for you to testify in the order that I introduced you. As perhaps you heard, your full statements will be made a part of the record. You may proceed with those in full or in summaries, and then please respond to our questions. Mr. Reinsch.

STATEMENT OF HON. WILLIAM A. REINSCH, PRESIDENT, NATIONAL FOREIGN TRADE COUNCIL, WASHINGTON, D.C.

Mr. REINSCH. Thank you, Mr. Chairman. I appreciate your comment about the full statements. Since I have ruthlessly tried to trim mine in order to fit within the time limit, I am glad you are going to put the whole thing in.

The National Foreign Trade Council was pleased to recommend ratification of the proposals that you are considering today. We appreciate your actions in particular, Mr. Chairman, in scheduling the hearing, and we strongly urge the committee to reaffirm the United States' historic opposition to double taxation by giving its full support to the pending Netherlands and Barbados protocols.

The NFTC, organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, and we seek to foster an environment in which U.S. companies can be dynamic and effective competitors in the international business arena. As global competition grows ever more intense, it is vital to the health of U.S. enterprises and to their continuing ability to contribute to the U.S. economy that they be free from excessive foreign taxes or double taxation and impediments to the flow of capital that can serve as barriers to full participation in the international marketplace. Foreign trade is fundamental to the economic growth of U.S. companies. Tax treaties are a crucial component of the framework that is necessary to allow that growth.

That is why the NFTC has long supported the expansion and strengthening of the U.S. tax treaty network and why we are here today to recommend ratification of the two protocols.

Tax treaties are bilateral agreements between the U.S. and foreign countries that serve to harmonize the tax systems of the two countries with respect to persons involved in cross-border investment and trade. Tax treaties eliminate this double taxation by allocating taxing jurisdiction over the income between the two countries. In the absence of tax treaties, income from international transactions or investment may be subject to double taxation, first by the country where the income arises and again by the country of the recipient's residence.

In addition, the tax systems of most countries impose withholding taxes, frequently at high rates, on payments of dividends, interest, and royalties to foreigners, and treaties are the mechanism by which these taxes are lowered on a bilateral basis. If U.S. enterprises earning such income abroad cannot enjoy the reduced foreign withholding rates offered by a tax treaty, they are liable to suffer excessive and non-creditable levels of foreign tax and to be at a competitive disadvantage relative to traders and investors from other countries that do have such benefits. Tax treaties serve to prevent this barrier to U.S. participation in international commerce.

If U.S. businesses are going to maintain a competitive position around the world, we need a treaty policy that protects them from multiple or excessive levels of foreign tax on cross-border investments, particularly if their competitors already enjoy that advantage. The U.S. has lagged behind other developed countries in eliminating this withholding tax and leveling the playing field for cross-border investment. The EU eliminated the tax on intra-EU parent-subsidiary dividends over a decade ago, and dozens of bilateral treaties between foreign countries have followed that route. The majority of OECD countries now have bilateral treaties in place that provide for a zero rate on parent-subsidiary dividends.

Taxpayers are not the only beneficiaries of tax treaties. Treaties protect the legitimate enforcement interests of the United States by providing for the administration of U.S. tax laws and the implementation of U.S. treaty policy. The article that provides for the exchange of information between tax authorities is an excellent example of the benefits that result from an expanded treaty network. Treaties also provide the possibility of administrative assistance in the collection of taxes between the relevant tax authorities.

The Netherlands protocol that is before the committee today updates a decade-old agreement. Its ratification will enhance an already well-established trading relationship that is one of the oldest and most significant for the United States. This protocol makes an important contribution toward improving the economic competitiveness of U.S. companies, especially relative to their EU counterparts.

The NFTC has for years urged adjustment of U.S. treaty policy to allow for a zero withholding rate on related-entity dividends, and we praise the Treasury for making further progress in this protocol with the Netherlands. The ownership threshold necessary to receive the benefit of the zero dividend withholding rate is 80 percent, as you have noted, which is in line with the corresponding provisions in the U.S.-UK treaty. Although we support a less stringent ownership requirement, preferring the 50 percent threshold in the U.S.-Japan agreement, we very much appreciate Treasury's commitment to eliminating this impediment to trade. We thank the committee for its prior support of this evolution in U.S. tax treaty policy and we strongly urge you to continue that support by approving the protocol to the Netherlands treaty.

Another notable inclusion in the Netherlands protocol is a section that would give reciprocal treatment to qualifying pension plans, another one that you noted, Mr. Chairman, allowing for the deductibility of contributions and making the corresponding distribution payments taxable. Modern U.S. tax treaty policy regarding hybrid entities and the application of reduced U.S. withholding rates on dividends paid by regulated investment companies and real estate investment trusts are also reflected in the protocol.

Important safeguards are included in the Netherlands protocol to prevent treaty shopping. For example, in order to qualify for the lowered rates specified by the agreement, companies must meet certain requirements so that foreigners, whose governments have not negotiated a tax treaty with the Netherlands or the United States, cannot free-ride on this agreement.

The protocol with Barbados also contains these important treaty shopping measures. The protocol amends a 20-year-old agreement with strict rules that preserve the purpose of the tax treaty network by ensuring that the benefits of the treaty are received by the intended beneficiaries.

The Senate's ratification of these agreements will help Treasury in its continuing effort to improve and enhance the U.S. tax treaty network by negotiating agreements with other countries. We are particularly hopeful that the Senate will be able to complete its ratification procedures before it adjourns this year so that these agreements become effective as soon as possible. Let me also say on that, Mr. Chairman, I am in the group of people who think

there is not going to be a lame duck session. So I hope that you are going to act soon, even though I may be wrong about that.

The NFTC also wishes to reaffirm its support for the existing procedure by which Treasury consults on a regular basis with this committee, also the tax-writing committees, and the appropriate congressional staffs concerning tax treaty issues and negotiations and the interaction between treaties and developing tax legislation. We encourage all participants in such consultations to give them a high priority. We also commend this committee for scheduling tax treaty hearings so soon after receiving the agreements from the executive branch. Doing so enables improvements in the treaty network to enter into effect as quickly as possible, and this committee's record under your chairmanship, Senator Lugar, has been exemplary.

Finally, the NFTC is grateful to the chairman and the members of the committee for giving international economic relations prominence in the committee's agenda. In particular, we want to express our gratitude for making time for a hearing before the end of this session, especially when demands on the committee's time are so pressing. We would also like to express our appreciation for the efforts of both the majority and minority staff which have facilitated the holding of this hearing at this time.

We commend the committee for its commitment to proceed with ratification of these important agreements as expeditiously as possible. Thank you, Mr. Chairman.

[The prepared statement of Mr. Reinsch follows:]

PREPARED STATEMENT OF WILLIAM A. REINSCH

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE: The National Foreign Trade Council (NFTC) is pleased to recommend ratification of the protocols under consideration by the committee today. We appreciate the Chairman's actions in scheduling this hearing, and we strongly urge the committee to reaffirm the United States' historic opposition to double taxation by giving its full support to the pending Netherlands and Barbados Protocols.

The NFTC, organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, and the NFTC therefore seeks to foster an environment in which U.S. companies can be dynamic and effective competitors in the international business arena. To achieve this goal, American businesses must be able to participate fully in business activities throughout the world, through the export of goods, services, technology, and entertainment, and through direct investment in facilities abroad. As global competition grows ever more intense, it is vital to the health of U.S. enterprises and to their continuing ability to contribute to the U.S. economy that they be free from excessive foreign taxes or double taxation and impediments to the flow of capital that can serve as barriers to full participation in the international marketplace. Foreign trade is fundamental to the economic growth of U.S. companies. Tax treaties are a crucial component of the framework that is necessary to allow that growth.

This is why the NFTC has long supported the expansion and strengthening of the U.S. tax treaty network and why we are here today to recommend ratification of the Protocols with the Netherlands and Barbados.

TAX TREATIES AND THEIR IMPORTANCE TO THE UNITED STATES

Tax treaties are bilateral agreements between the United States and foreign countries that serve to harmonize the tax systems of the two countries with respect to persons involved in cross-border investment and trade. Tax treaties eliminate this double taxation by allocating taxing jurisdiction over the income between the two countries. In the absence of tax treaties, income from international transactions or

investment may be subject to double taxation, first by the country where the income arises and again by the country of the recipient's residence.

In addition, the tax systems of most countries impose withholding taxes, frequently at high rates, on payments of dividends, interest, and royalties to foreigners, and treaties are the mechanism by which these taxes are lowered on a bilateral basis. If U.S. enterprises earning such income abroad cannot enjoy the reduced foreign withholding rates offered by a tax treaty, they are liable to suffer excessive and non-creditable levels of foreign tax and to be at a competitive disadvantage relative to traders and investors from other countries that do have such benefits. Tax treaties serve to prevent this barrier to U.S. participation in international commerce.

If U.S. businesses are going to maintain a competitive position around the world, we need a treaty policy that protects them from multiple or excessive levels of foreign tax on cross-border investments, particularly if their competitors already enjoy that advantage. The United States has lagged behind other developed countries in eliminating this withholding tax and leveling the playing field for cross-border investment. The European Union (ELT) eliminated the tax on intra-EU, parent-subsidiary dividends over a decade ago and dozens of bilateral treaties between foreign countries have also followed that route. The majority of OECD countries now have bilateral treaties in place that provide for a zero rate on parent-subsidiary dividends.

Tax treaties also provide other features that are vital to the competitive position of U.S. businesses. For example, by prescribing internationally agreed thresholds for the imposition of taxation by foreign countries on inbound investment, and by requiring foreign tax laws to be applied in a nondiscriminatory manner to U.S. enterprises, treaties offer a significant measure of certainty to potential investors. Another extremely important benefit that is available exclusively under tax treaties is the mutual agreement procedure. This bilateral administrative mechanism avoids double taxation on cross-border transactions.

Taxpayers are not the only beneficiaries of tax treaties. Treaties protect the legitimate enforcement interests of the United States by providing for the administration of U.S. tax laws and the implementation of U.S. treaty policy. The article that provides for the exchange of information between tax authorities is an excellent example of the benefits that result from an expanded tax treaty network. Treaties also offer the possibility of administrative assistance in the collection of taxes between the relevant tax authorities.

A framework for the resolution of disputes with respect to overlapping claims by the respective governments is also provided for in tax treaties. In particular, the practices of the Competent Authorities under the treaties have led to agreements, known as "Advance Pricing Agreements" or "APAs," through which tax authorities of the United States and other countries have been able to avoid costly and unproductive proceedings over appropriate transfer prices for the trade in goods and services between related entities. APAs, which are agreements jointly entered into between one or more countries and particular taxpayers, have become common and increasingly popular procedures for countries and taxpayers to settle their transfer pricing issues in advance of dispute. The clear trend is that treaties are becoming an increasingly important tool used by tax authorities and taxpayers alike in striving for fairer and more efficient application of the tax laws.

AGREEMENTS BEFORE THE COMMITTEE

The Netherlands Protocol that is before the committee today updates a decade old agreement. Its ratification will enhance an already well established trading relationship that is one of the oldest and most significant for the United States. This Protocol makes an important contribution toward improving the economic competitiveness of U.S. companies, especially relative to their EU counterparts.

The NFTC has for years urged adjustment of U.S. treaty policy to allow for a zero withholding rate on related-entity dividends, and we praise the Treasury for making further progress in this Protocol with the Netherlands. The ownership threshold necessary to receive the benefit of the zero dividend withholding rate is 80 percent, which is in line with the corresponding provision in the U.S.-UK treaty. Although we support a less stringent ownership requirement, preferring the 50 percent threshold in the U.S.-Japan Agreement, we very much appreciate Treasury's commitment to eliminating this impediment to trade. We thank the committee for its prior support of this evolution in U.S. tax treaty policy and we strongly urge you to continue that support by approving the Protocol to the Netherlands Treaty.

The existence of a withholding tax on cross-border, parent-subsidiary dividends, even at the 5 percent rate previously in the U.S.-Netherlands treaty has served as

a tariff like barrier to cross-border investment flows. Without a zero rate, the combination of the underlying corporate tax and the withholding tax on the dividend will often lead to unusable excess foreign tax credits in the parent's hands, resulting in a lower return from a cross-border investment than a comparable domestic investment. This sort of multiple taxation of profits within a corporate group leads to exactly the kind of distortion in investment decisions that tax treaties are meant to prevent.

Another notable inclusion in the Netherlands Protocol is a section that would give reciprocal treatment to qualifying pension plans, allowing for the deductibility of contributions and making the corresponding distribution payments taxable. Modem U.S. tax treaty policy regarding hybrid entities and the application of reduced U.S. withholding rates on dividends paid by Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs) are also reflected in the protocol.

Important safeguards are included in the Netherlands Protocol to prevent treaty shopping. For example, in order to qualify for the lowered rates specified by the agreement, companies must meet certain requirements so that foreigners whose governments have not negotiated a tax treaty with the Netherlands or the United States cannot free-ride on this agreement.

The protocol with Barbados also contains these important treaty shopping measures. The protocol amends a twenty year old agreement with strict rules that preserve the purpose of the tax treaty network by ensuring that the benefits of the treaty are received by the intended beneficiaries.

The Senate's ratification of these agreements will help Treasury in its continuing effort to improve and enhance the U.S. tax treaty network by negotiating agreements with other countries. We are particularly hopeful that the Senate will be able to complete its ratification procedures by the end of this Congressional year so that these agreements become effective as soon as possible.

GENERAL COMMENTS ON TAX TREATY POLICY

While we are not aware of any opposition to the treaties under consideration, the NFTC as it has done in the past as a general cautionary note, urges the committee to reject opposition to the agreements based on the presence or absence of a single provision. No process that is as laden with competing considerations as the negotiation of a full-scale tax treaty between sovereign states will be able to produce an agreement that will completely satisfy every possible constituency, and no such result should be expected. Virtually all treaty relationships arise from difficult and sometimes delicate negotiations aimed at resolving conflicts between the tax laws and policies of the negotiating countries. The resulting compromises always reflect a series of concessions by both countries from their preferred positions. Recognizing this, but also cognizant of the vital role tax treaties play in creating a level playing field for enterprises engaged in international commerce, the NFTC believes that treaties should be evaluated on the basis of their overall effect. In other words, agreements should be judged on whether they encourage international flows of trade and investment between the United States and the other country. An agreement that meets this standard will provide the guidance enterprises need in planning for the future, provide nondiscriminatory treatment for U.S. traders and investors as compared to those of other countries, and meet a minimum level of acceptability in comparison with the preferred U.S. position and expressed goals of the business community.

Mechanical comparisons of a particular treaty's provisions with the U.S. Model or with treaties with other countries do not provide an appropriate basis for analyzing a treaty's value. U.S. negotiators are to be applauded for achieving agreements that reflect as well as these agreements do the positions of the U.S. Model and the views expressed by the U.S. business community.

The NFTC also wishes to emphasize how important treaties are in creating, implementing, and preserving an international consensus on the desirability of avoiding double taxation, particularly with respect to transactions between related entities. The United States, together with many of its treaty partners, has worked long and hard through the OECD and other fora to promote acceptance of the arm's length standard for pricing transactions between related parties. The worldwide acceptance of this standard, which is reflected in the intricate treaty network covering the United States and dozens of other countries, is a tribute to governments' commitment to prevent conflicting income measurements from leading to double taxation and resulting distortions and barriers for healthy international trade. Treaties are a crucial element in achieving this goal, because they contain an expression of both governments' commitment to the arm's length standard and provide the only

available bilateral mechanism, the competent authority procedure, to resolve any disputes about the application of the standard in practice.

We recognize that determination of the appropriate arm's length transfer price for the exchange of goods and services between related entities is sometimes a complex task that can lead to good faith disagreements between well-intentioned parties. Nevertheless, the points of international agreement on the governing principles far outnumber any points of disagreement. Indeed, after decades of close examination, governments around the world agree that the arm's length principle is the best available standard for determining the appropriate transfer price, because of both its economic neutrality and its ability to be applied by taxpayers and revenue authorities alike by reference to verifiable data.

The NFTC strongly supports the efforts of the Internal Revenue Service and the Treasury to promote continuing international consensus on the appropriate transfer pricing standards, as well as innovative procedures for implementing that consensus. We applaud the continued growth of the APA program, which is designed to achieve agreement between taxpayers and revenue authorities on the proper pricing methodology to be used before disputes arise. We commend the ongoing efforts of the IRS to refine and improve the operation of the competent authority process under treaties to make it a more efficient and reliable means of avoiding double taxation.

The NFTC also wishes to reaffirm its support for the existing procedure by which Treasury consults on a regular basis with this committee, the tax-writing committees, and the appropriate Congressional staffs concerning tax treaty issues and negotiations and the interaction between treaties and developing tax legislation. We encourage all participants in such consultations to give them a high priority. We also commend this committee for scheduling tax treaty hearings so soon after receiving the agreements from the Executive Branch. Doing so enables improvements in the treaty network to enter into effect as quickly as possible.

We would also like to reaffirm our view, frequently voiced in the past, that Congress should avoid occasions of overriding the U.S. tax treaty commitments that are approved by this committee by subsequent domestic legislation. We believe that consultation, negotiation, and mutual agreement upon changes, rather than unilateral legislative abrogation of treaty commitments, better supports the mutual goals of treaty partners.

IN CONCLUSION

Finally, the NFTC is grateful to the Chairman and the members of the committee for giving international economic relations prominence in the committee's agenda. In particular, we want to express our gratitude for making time for a hearing before the end of this session, especially when the demands upon the committee's time are so pressing. We would also like to express our appreciation for the efforts of both majority and minority staff which have allowed this hearing to be scheduled and held at this time.

We commend the committee for its commitment to proceed with ratification of these important agreements as expeditiously as possible.

The CHAIRMAN. Well, thank you very much for your commendations of our efforts. Let me just say parenthetically we do take the time table seriously. Even though the Congress may be in recess, the rest of American working people are not, and the tax implications continue on whether we are here or not. So we appreciate this opportunity to have you testify today to fulfill our obligation for a full-fledged hearing and a committee record. My reason for interrogating the previous witnesses so thoroughly is just to make certain we do have that record. These questions have been raised and have been responded to. Likewise, we will do so with you.

Now, let me again commend our staffs who have to be extremely talented and diligent at this point in the session because much that we do must now happen by unanimous consent or relatively unanimous consent and this requires bipartisanship and it requires thoughtfulness as Americans as opposed to partisans.

So we have been active. Staff was last evening on the floor. We succeeded in passing a very important piece of committee legisla-

tion with regard to Sudan, for example, somewhat distant from our purview this morning, but nevertheless an example of legislation that is timely and required, as we feel these treaties are.

So we thank you again for your participation.

Now, Ms. Zelisko, we would love to hear from you and if you will proceed.

STATEMENT OF JUDITH P. ZELISKO, PRESIDENT, TAX EXECUTIVES INSTITUTE, WASHINGTON, D.C.

Ms. ZELISKO. Thank you, Mr. Chairman. Good morning. I am Judy Zelisko, Vice President of Tax for Brunswick Corporation. I am here today as President of Tax Executives Institute whose 5,400 members work for 2,800 of the largest companies in North America and Europe. TEI appreciates the opportunity to present its views on these two important protocols.

Tax Executives Institute was established in 1944 to serve the professional needs of in-house tax practitioners. Today the institute has 53 chapters in the United States, Canada, and Europe. Our 5,400 members are accountants, attorneys, and other business professionals who work for the 2,800 leading companies in North America and Europe. They are responsible for conducting the tax affairs of their companies and ensuring their compliance with the tax laws.

The majority of TEI's members work for multinational companies with substantial international operations and sales. Members of TEI must contend daily with the provisions of the various tax laws relating to the operation of business enterprises. Consequently, TEI members have a special interest in the tax treaty between the United States and the Netherlands, as well as the one between the United States and Barbados.

A fundamental purpose of America's income tax treaties is to eliminate double taxation, which constitutes a significant burden on international trade and investment and hence impedes economic growth. We are pleased that the United States has sought to update the Dutch treaty since the current treaty does not reflect recent advancements in U.S. policy. The Dutch protocol under consideration by the committee will eliminate barriers to trade and investment between the two countries, curtail abuse, and promote cooperation in international enforcement. Prompt ratification will promote closer ties with a longstanding ally and major trading partner, encourage growth of the U.S. economy and jobs, and enhance tax enforcement efforts.

A principal benefit of the Dutch protocol for business is the elimination of the withholding tax on dividends. This will encourage U.S. multinationals to bring offshore earnings back to the United States, thereby aiding the domestic economy.

Another benefit is the article modernizing the cross- border treatment of pension funding and benefits by coordinating the two countries' rules. This will permit citizens of each country to transfer between affiliated companies without jeopardizing the status of their retirement benefits. It will also encourage investment by Dutch companies in the United States, as well as enable U.S. companies to provide their U.S. citizen employees who transfer overseas, for

example, on temporary assignment, with the same pension benefits as their U.S.-based colleagues.

Finally, the Dutch protocol will improve the exchange of information between the U.S. and Dutch tax authorities. This will aid both countries' enforcement efforts against tax shelters and other abusive transactions. The new protocol will also enhance the ability of the competent authorities to minimize double taxation by improving the procedures for reaching mutual agreement on tax issues.

TEI, therefore, urges the committee to approve the new agreement with the Netherlands.

Turning to the second protocol of today, the U.S.- Barbados treaty, we note that like the Dutch protocol the Barbados' agreement is designed to bring the current treaty in line with U.S. policy and put adequate safeguards in place to prevent inappropriate use of the treaty. To accomplish these objectives, the protocol expands the existing limitation on benefits article to modernize the anti-treaty-shopping provisions. The Treasury Department believes that the more restrictive terms will address concerns about the unintended use of the treaty by companies to migrate their corporate structures offshore.

Although TEI has some reservations about expanding limitation on benefits to U.S. treaties generally without thorough analysis, on balance we agree ratification of the Barbados protocol is in the best interest of the country and the business community.

Tax Executives Institute commends the Foreign Relations Committee for holding this hearing. To enable the Internal Revenue Service and U.S. taxpayers to reap the benefits of the new agreements, we urge their prompt ratification.

I would be pleased to respond to any questions you might have.

[The prepared statement of Ms. Zelisko follows:]

PREPARED STATEMENT OF JUDITH P. ZELISKO

Good afternoon. I am Judy Zelisko, Vice President-Tax for Brunswick Corporation. I am here today as President of Tax Executives Institute, whose 5,400 members work for 2,800 of the largest companies in North America and Europe. TEI appreciates the opportunity to present its views on these two important protocols.

Tax Executives Institute was established in 1944 to serve the professional needs of in-house tax practitioners. Today, the Institute has 53 chapters in the United States, Canada, and Europe. Our 5,400 members are accountants, attorneys, and other business professionals who work for 2,800 of the leading companies in North America and Europe; they are responsible for conducting the tax affairs of their companies and ensuring their compliance with the tax laws.

The majority of TEI's members work for multinational companies with substantial international operations and sales. Members of TEI are responsible for managing the tax affairs of their companies and must contend daily with the provisions of the various tax laws relating to the operation of business enterprises. Consequently, TEI members have a special interest in the tax treaty to bring off-shore earnings back to the United States, thereby aiding the domestic economy.

Another benefit is the article modernizing the cross-border treatment of pension funding and benefits by coordinating the two countries' rules. This will permit citizens of each country to transfer between affiliated companies without jeopardizing the status of their retirement benefits. It will also encourage investment by Dutch companies in the United States, as well as enable U.S. companies to provide their U.S. citizen employees who transfer overseas, for example, on temporary assignment, with the same pension benefits as their U. S.-based colleagues.

Finally, the Dutch Protocol will improve the exchange of information between U.S. and Dutch tax authorities. This will aid both countries' enforcement efforts against tax shelters or other abusive transactions. The new protocol will also enhance the

ability of the Competent Authorities to minimize double taxation by improving the procedures for reaching mutual agreement on tax issues.

TEI therefore urges the committee to approve the new agreement with the Netherlands.

Turning to the Second Protocol to the U.S.-Barbados treaty, we note that—like the Dutch Protocol—the Barbados agreement is designed to bring the current treaty in line with U.S. policy and put adequate safeguards in place to prevent inappropriate use of the treaty. To accomplish these objectives, the Protocol expands the existing Limitation on Benefits article to modernize the treaty's anti-treaty-shopping provision. The Treasury Department believes that the more restrictive terms will address concerns about the unintended use of the treaty by companies that purport to migrate their corporate structures off-shore.

Although TEI has some reservations about the limiting effect that the Barbados Protocol may potentially have on legitimate tax planning, on balance we agree ratification is in the best interest of the country and the business community.

Tax Executives Institute commends the Foreign Relations Committee for holding this public hearing. To enable the Internal Revenue Service and U.S. taxpayers to reap the benefits of the new agreements, we urge their prompt ratification. I would be pleased to respond to any questions you may have.

The CHAIRMAN. Well, thank you very much for that testimony.

Let me ask you, Ms. Zelisko, what would be the most significant impact of each of these two protocols—they are very different in a sense, different country size and situation—but the impact on tax planning for U.S. nationals? You are representing the tax practitioners in the largest firms in our country obviously involved in tax planning strategy for your company and representing others today. What is likely to be the most significant impact that you see as a tax planner or as a leader of those who are involved in that field?

Ms. ZELISKO. Thank you, Mr. Chairman.

With regard to the Netherlands, it is the third largest investor in the United States, and the United States is a significant investment in the Netherlands. This new protocol would eliminate the trade barrier by permitting companies to repatriate earnings without a withholding tax. So I think companies that have not traditionally paid dividends may reassess that policy and obviously impact the U.S. economy I think positively.

It will also permit increased investment in the United States by Dutch companies by eliminating the branch profits tax.

By limiting benefits to residents of both countries, the new protocol will also curb the inappropriate use of treaty shopping. So I think those are the major impacts that the two protocols will have.

The CHAIRMAN. The dividend impact. Describe that just in layperson's terms if you will. What do companies do now? Do they accumulate the money in one place and do not pay it out to their stockholders because of tax implications? Or how will this affect income coming into the United States?

Ms. ZELISKO. When companies are operating overseas and they are profitable, they are obviously having a positive cash flow and accumulating cash, and then when assessing whether or not you are going to bring those funds home, one of the factors that you have to consider is obviously the tax cost of that. And depending upon the tax position of the company, if they happen to be in an excess tax credit position, the fact that you would also have a withholding tax, obviously increases the amount of credits that that company would have to absorb. And if they are in an excess credit position, Mr. Chairman, that is a net cost because they would have to have paid an additional tax. They cannot currently then offset

that against their income because of the limitation calculation that we have to go through. Then that is a net cost of bringing those funds home. So consequently, they would basically obviously, depending upon other factors of the economics of the company, keep those funds overseas.

The CHAIRMAN. So, in essence, at least there is a more likely decision to bring some of that money back to the United States to shareholders here who then will reap the benefits of that. They would reap them anyway, but it would be somewhere else, sort of in the hereafter as opposed to as a part of immediate income to them and to our country.

Ms. ZELISKO. Exactly. Again, like anything else, it is a business decision, but obviously cost of funds is an important one.

The CHAIRMAN. Now, how do you gauge that enactment of these protocols will affect worker flow between the United States and the Netherlands or Barbados? Do you have any comment as to what is going to happen with regard to workers coming and going?

Ms. ZELISKO. I think certainly with regard to the Dutch protocol that we are looking at here today, employees who transfer overseas can often be whipsawed by the divergent pension rules that I mentioned earlier, sometimes being taxed when the pensions are funded and then again when they are distributed. The Dutch protocol specifically addresses this issue and coordinates the two countries' rules on pension funding and benefits, which will therefore permit U.S. companies to more freely transfer their workers among their operations without jeopardizing the status of their pension benefits, which obviously is, therefore, going to increase the worker flow potentially for temporary assignments and again reduce the barrier to that flow.

The CHAIRMAN. Now, both protocols before the committee attempt to strengthen the ability of each country's tax authorities to exchange information about taxpayers when necessary. How has that lack of ability to exchange information impacted your members?

Ms. ZELISKO. Well, again, I think anytime there is an increased information flow, I think that is positive. More specifically, governments obviously are involved in the enforcement of their tax laws and to have that information available is important because the extent of those exchanges provide a more level playing field for all concerned, for all taxpayers. Companies that do not engage in those abusive transactions will benefit by being able to compete more effectively, Mr. Chairman.

The CHAIRMAN. Just as a general question from your expertise, obviously the provisions of these treaties we generally see as advances, but what do you consider to be the most significant tax barriers that remain in cross-border investment? If we are talking about the model treaty or about additional treaties, what sort of considerations should Treasury or the relevant committees of the Congress be considering?

Ms. ZELISKO. Well, not only with regard to, I think, tax treaties, Mr. Chairman, but also with regard to tax legislation I think have major implications with regard to competitiveness of U.S. businesses. The high U.S. tax rate on corporations may act as a barrier to cross-border investments. In addition, U.S. tax laws may make

it more difficult for U.S. companies to compete effectively overseas. U.S. companies face double taxation because of U.S. tax laws that, for example, allocate U.S. interest and other expenses against foreign source income for purposes of the foreign tax credit. In addition, U.S. companies that experience losses domestically while earning income abroad suffer a reduction in the foreign tax credit limitations which is important when you are trying to bring funds home from overseas. Finally, the alternative minimum tax limits, the amount of foreign tax credits the company may use, is also a barrier. Many of these provisions are addressed in legislation currently pending before Congress.

The CHAIRMAN. Yes, not necessarily in these treaties but more generally.

Ms. ZELISKO. More generally.

The CHAIRMAN. And perhaps will receive action. I raise it only in this context because sometimes constructive things have been occurring through the treaty provisions. This is not a substitute for wholesale tax reform, but sometimes that has been hard for the Congress to come to grips with. But I appreciate your comment. This is very helpful.

Mr. Reinsch, let me just ask you for a general thought. You have appeared now before the committee on each of these occasions when we have been taking up tax treaties and commended the committee for doing so with the UK, Australia, Mexico, Japan, Sri Lanka. How has the enactment of these treaties, prior to our consideration today of the Netherlands and Barbados, affected the flow of trade between the United States and the companies that have been affected? Have you seen any changes?

Mr. REINSCH. We expect it will have a positive effect, Mr. Chairman, but the truth is it is too soon to say. As you know, most of them have a lag in effective date. I think the Japan treaty, for example, substantial parts of it, will not go into effect until January 1 I think.

The CHAIRMAN. Next year.

Mr. REINSCH. In addition, there is a data lag particularly for investment of a year or more. The trade lag is a little bit less. And in some cases, Australia being the primary example, we will probably never be able to tell because we are implementing a free trade agreement with them at the same time and trying to sort out what is a consequence of what action would be impossible. But we are expecting a favorable result. One of the things that we can do as part of our annual survey of our members on this subject is to ask them that question.

The CHAIRMAN. I would appreciate that. You do have a membership that is very sensitive to these issues and is likely to be prescient as to what the data that does have a lag, as you say, may show. So to the extent that you can forward that to the committee or make it general public knowledge, this is very helpful as we proceed in these considerations of tax treaties in this debate.

Mr. REINSCH. We would be pleased to.

The CHAIRMAN. Now, can you estimate how many United States companies are currently doing business or have investments in the Netherlands? I cited maybe 1,600 as our best view right now, which is a lot of American companies. Maybe you have additional

data on this. I am simply curious why so many American companies are in the Netherlands; likewise, vice versa, why the volume of trade and investment has been so large. This is the third largest situation that we have considered. What are the characteristics of this relationship that have led to this?

Mr. REINSCH. Well, I think first of all, Mr. Chairman, we do not have better data than you. This regularly shows up as a significant country, as I said, in the survey that we conduct. Approximately half our member companies have participated, and our tax committee survey indicated that this was a significant country as far as their business is concerned.

I think the reasons for the extent of the depth and breadth of the trade relationship in what is a small country is largely historic. You have, first of all, a long-term positive relationship with the Netherlands that goes back hundreds of years. You have a country there that has been one of the foremost trading and investing outward nations in Europe for a long time. You have had substantial Dutch investment in the United States for years, probably second in Europe only to the UK. A lot of our companies locate either their headquarters or various planning facilities there for their European operations. These are not in every case large manufacturing establishments, but they are either corporate headquarters or various divisions that do planning. It is centrally located. Transportation is efficient. It is linguistically convenient, if you will. Virtually everybody speaks English, which is not true in some countries to the south. And as a result, it is just a very attractive location, and there has been a lot of, in a sense, reciprocation of that attractiveness, with Dutch investment coming here over the years.

The CHAIRMAN. Well, thank you very much for that testimony. I would indicate that this committee—and I am sure I speak for our country—very much appreciates the relationship we have with the Netherlands in areas that are outside the purview that we are discussing today. But it is a very important relationship. It is very important we take seriously these tax provisions and the commercial possibility of the equity that may come from these revisions.

Let me just ask you the same question that I asked Ms. Zelisko. As you review with your members particular concerns on the model treaty, are you regularly in touch with Treasury, the joint committee, with us, with anybody? In other words, can you give us some idea of how the communication goes so that we are all thinking along the same track, and when we come to conclusions, then actually draft a treaty for formal ratification, that we have got it right?

Mr. REINSCH. Yes, certainly Mr. Chairman. I have to say I was amused in the previous panel on this issue you asked the same question that you asked 6 months ago and you got the same answer. I hope that we continue to make progress. I am going to try not to give you quite the same answer. You have asked me a different question, so I know you will get a different answer.

We have a very constructive and I think positive relationship with the Treasury, particularly with Ms. Angus. She has regularly visited with us virtually on request. Our tax committee has two big meetings a year, fall and spring. She has consistently been both a guest speaker at both meetings annually, as well as spending con-

siderable time, both before and after her remarks, to stay in touch with our individual members. We have a very direct, very clear channel of communication, both with her and her colleagues at the Treasury, virtually at any moment, and my colleague, Judy Scarabello, who is our Vice President for Tax, has been known to call her evenings, weekends, at virtually any moment. We have shared our survey information with her and would like to think that the Treasury has used that as input, particularly in focusing on where they would like to go next because that is one of the key questions we ask our members, what countries are of interest to them.

So we are very pleased with the two-way nature of the relationship. She and her colleagues have not been shy about asking our opinion of things and also telling us when things that we want are not going to happen. And that is a relationship that we respect and appreciate.

The CHAIRMAN. Well, I thank you for that reassurance. The purpose of raising the question is really to make sure we all stay in touch.

Mr. REINSCH. I say the same thing, Mr. Chairman, with respect to the committee. We have had a very constructive working relationship with the staff on both sides of the aisle, and we look forward to continuing it.

The CHAIRMAN. I would just underline the fact that clearly you and the companies that you represent are exhorted constantly by all Americans to do more. We have an enormous balance of trade deficit. The need for American companies to be more successful exporters and to engage more successfully in international business is obviously apparent. There are some alarmists on the scene that see these deficits and their accumulation as an impending source of genuine concern for our entire economy and for the incomes of Americans. So what we are talking about today is very serious in terms of our foreign policy and our national strength.

But having said that, we appreciate especially the witness of both of you on the technical aspects of taxes because this affects numbers of decisions as to how aggressive Americans want to be in terms of their foreign trade aspect and in terms of looking at those markets and then the fairness to each of the firms you represent because you both have broad constituencies of companies involved in all sorts of business that you have to consider as you think of your testimony.

I have no more questions, but I would ask either of you if you have additional testimony or thoughts that have arisen as you have listened to the testimony, why, please give us the benefit of that presently. Do you have anything further you would like to comment, Ms. Zelisko?

Ms. ZELISKO. The only thing I would like to add, Mr. Chairman, is that we also have a very good relationship with Ms. Angus with regard to, obviously, free flow of communication and input and make comments regularly with regard to whether it is treaties or proposed legislation. So again, I think that is very helpful for both sides.

The CHAIRMAN. Well, that is reassuring. Just out of curiosity, where are your headquarters? Located here in Washington?

Ms. ZELISKO. Yes, we are, sir.

The CHAIRMAN. And do you have regular board meetings, conventions, or how does the input of your members come to you?

Ms. ZELISKO. Well, we are governed by an executive committee, but we have an annual conference and a mid-year conference, which the mid-year is held here in Washington every year. And people from the Treasury are regular speakers at our conferences. We have an annual liaison meeting with Treasury, usually in February, in which issues are raised by our members which we solicit through our various committees that we have, and given that we are global in nature, we also have a very robust European chapter that has over 200 members companies, so obviously many members in the Netherlands as well talking here today. Consequently, we have a broad breadth of input with regard to the issues that face basically companies not only in the United States but the impact of those laws on our counterparts outside the United States.

The CHAIRMAN. Thus, in your deliberation of members with the Treasury, at least a portion of those meetings has an international content I suspect, both because you have the European chapters, but likewise because you are interested in the equities of the type of consideration we have here today.

Ms. ZELISKO. Yes, exactly.

The CHAIRMAN. Very good.

Now, how do you interact with your members, Mr. Reinsch?

Mr. REINSCH. Well, as much as possible. We do a wide variety of things, in addition to taxes, as you well know from our other interactions.

The CHAIRMAN. Yes.

Mr. REINSCH. In this particular area, we have a tax committee which has itself a steering committee. The steering committee meets every 6 weeks, and it is both a meeting to discuss our agenda and what matters to our members. Also, we usually have a guest speaker oftentimes someone from the Treasury, but not always, to get an update on a matter of interest.

We do an annual survey, as I indicated, specifically on treaties, and that then becomes our working agenda for our treaty goals for the year.

We have two large meetings for the general membership, one in the spring that is out of town, and one in the fall that is here in Washington.

The CHAIRMAN. As you have considered future work by Treasury, yourselves, or us on treaties, are there certain countries that come to mind or certain categories or parts of the world? Can you give us any forecast of where your recommendations will be?

Mr. REINSCH. I am glad you asked that, Mr. Chairman. The big two are Canada and Brazil, neither of which have evidenced much interest in a negotiation unfortunately.

The CHAIRMAN. It is unfortunate.

Mr. REINSCH. We give the Treasury a great deal of credit for its efforts, and they continue to beat on the door and try to make these things move forward. Those are both important economies where there is substantial U.S. business and significant tax problems that we would like to see addressed.

Beyond that, I think there are other EU countries, Germany being an example, where it would be nice to update the treaty and put in the zero withholding provision as well. But the big two that are sort of lurking out there are Canada and Brazil.

The CHAIRMAN. Well, you raise an important issue because even if we are eager to visit about reform, sometimes our partners are not. It is not axiomatic, that we get excited and suddenly it happens. I think that is an important point in foreign relations generally, as many of us have found in treaties on other sorts of issues. But at the same time, I appreciate your candid answer because it does focus at least some public attention on the fact that some progress could be made with our good friends in Canada and Brazil. We hope they might be more forthcoming and likewise others.

Well, I thank both of you again for your expert testimony, for coming again to the committee, and for your ongoing cooperation as you have illuminated that today. We will do our best to move these treaties to conclusion during this session of the Congress, and we ask you to continue to help us and to follow these activities.

Ms. ZELISKO. Thank you very much, Mr. Chairman.

Mr. REINSCH. Thank you.

The CHAIRMAN. Having said that, the hearing is adjourned.

[Whereupon, at 11:09 the hearing was adjourned.]

APPENDIX

STATEMENT SUBMITTED FOR THE RECORD BY SENATOR GEORGE ALLEN OF VIRGINIA

I want to thank you for your leadership in scheduling this hearing regarding mutually beneficial income tax protocols with close United States trading partners such as the Netherlands. On March 8, 2004, the US and the Netherlands signed a protocol to the existing U.S./Dutch income tax treaty, which among other matters, provides for the exemption from withholding tax on corporate dividends. By eliminating double taxation of international income, we will promote direct foreign investment which will encourage a growing US economy and increasing U.S. employment. Current Dutch law imposes a general withholding tax on U.S. based companies similar to that imposed by the U.S. Consequently an exemption from the withholding tax on dividends under the new protocol would also benefit U.S. based companies. The bottom line here is that the U.S./Dutch tax protocol is beneficial to both parties.

The Netherlands is the third largest investor in the U.S., having invested $155 billion in the US in 2002. Additionally, the Netherlands is a significant importer of U.S. goods and services with imports of $18.3 billion in 2002. The US has been running a trade surplus with the Dutch of approximately $8.5 billion per year.

The U.S. is the largest investor in the Netherlands and the Netherlands is the third largest recipient of U.S. direct investment behind only the U.K. and Canada.

The timing is especially auspicious for Senate ratification of the U.S./Dutch protocol in light of the fact that the Netherlands, a staunch U.S. ally. We appreciate and applaud the Netherlands for sending troops to help in the transition to democracy and peace in Iraq and for their efforts to promote a productive transatlantic partnership between the U.S. and the E.U. The Dutch have had the oldest continuous trade relationship with the U.S., longer than any other trading partner. As I understand it, Senate ratification of the protocol is a high priority for both the U.S. and Dutch governments.

The Dutch Parliament ratified the protocol in July and I hope that we can reciprocate by ensuring Senate ratification before we adjourn in October. Thank you again Mr. Chairman for moving forward on important tax protocols and on many other key foreign policy matters.

TECHNICAL EXPLANATIONS OF THE TREATIES

PREPARED BY THE UNITED STATES DEPARTMENT OF THE TREASURY

DEPARTMENT OF THE TREASURY TECHNICAL EXPLANATION OF THE PROTOCOL SIGNED AT WASHINGTON ON MARCH 8, 2004, AMENDING THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE KINGDOM OF THE NETHERLANDS FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, SIGNED AT WASHINGTON ON DECEMBER 18, 1992

This is a technical explanation of the Protocol signed at Washington on March 8, 2004 (the "Protocol"), amending the Convention between the United States of America and the Kingdom of the Netherlands for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, signed at Washington on December 18, 1992 (the "1992 Convention"), as amended by a protocol signed at Washington on October 13, 1993 (the "1993 Protocol"). The term "Convention" refers to the 1992 Convention as modified by both the 1993 Protocol and the Protocol.

Negotiations took into account the U.S. Treasury Department's current tax treaty policy and the Treasury Department's Model Income Tax Convention, published on September 20, 1996 (the "U.S. Model"). Negotiations also took into account the Model Tax Convention on Income and on Capital, published by the Organization for Economic Cooperation and Development, as updated in January 2003 (the "OECD Model"), and recent tax treaties concluded by both countries.

The Technical Explanation is an official guide to the Protocol It reflects the policies behind particular Protocol provisions, as well as understandings reached with respect to the application and interpretation of the Protocol and the 1992 Convention. This Technical Explanation should be read together with the Technical Explanation to the 1992 Convention with respect to provisions that have not been modified.

The Protocol was accompanied by a detailed Understanding, implemented through an exchange of notes, indicating the views of the negotiators and of the States with respect to a number of provisions of the Convention. The Understanding supersedes the Understanding accompanying the 1992 Convention and the related exchange of notes accompanying the 1993 Protocol. The portions of the Understanding that have been added (as opposed to being merely repeated) are discussed in connection with the relevant portions of the Protocol.

Paragraph XXXVIII of the Understanding provides that the United States and the Netherlands will consult together at regular intervals regarding the terms, operation and application of the Convention to ensure that it continues to serve the purposes of avoiding double taxation and preventing fiscal evasion. The first such consultation will take place no later than December 31st of the fifth year following the date on which the Protocol enters into force in accordance with the provisions of Article 10 of the Protocol. Further consultations shall take place thereafter at intervals of no more than five years. The Understanding also provides that the United States and the Netherlands will conclude further protocols to amend the Convention, if appropriate.

References in the Technical Explanation to "he" or "his" should be read to mean "he or she" or "his or her."

ARTICLE 1

Article 1 of the Protocol modifies Article I (General Scope) of the Convention to add new paragraph 3. Paragraph 3 specifically relates to the application to the Convention of dispute-resolution procedures and non-discrimination provisions under other agreements. The provisions of paragraph 3 are an exception to the rule provided in subparagraph (b) of paragraph 2 of Article 1 under which the Convention shall not restrict in any manner any benefit now or hereafter accorded by any other agreement between the Contracting States.

Clause (i) of subparagraph (a) of paragraph 3 provides that, notwithstanding any other agreement to which the Contracting States may be parties, a dispute concerning the interpretation or application of the Convention, including a dispute concerning whether a measure is within the scope of the Convention, shall. be consid-

ered only by the competent authorities of the Contracting States, and the procedures under Article 29 (Mutual Agreement Procedure) of the Convention exclusively shall apply to the dispute. Thus, dispute-resolution procedures that may be incorporated into trade, investment, or other agreements between the Contracting States shall not apply in determining the scope of the Convention.

Clause (ii) of subparagraph (a) of paragraph 3 provides that the national treatment provisions of Article XVII of the General Agreement on Trade in Services ("GATS") shall not apply to any "measure" unless the competent authorities agree that such measure is not within the scope of the non-discrimination provisions of Article 28 (Non-Discrimination) of the Convention. Subparagraph (b) of paragraph 3 defines the term "measure" to mean a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action, as related to taxes of every kind and description imposed by a Contracting State. Accordingly, no national treatment obligation undertaken by a Contracting State pursuant to GATS shall apply to a measure, unless the competent authorities agree that it is not within the scope of the Convention. The provision does not provide any limitation on the application of the most favored nation obligation ("MFN") of Article II of GATS. Because there is no MFN obligation in the Convention, there can be no conflict between the Convention and the MFN obligation of GATS.

Unlike the analogous provision in the U.S. Model, paragraph 3. does not include limitations on the application of the national treatment and MFN obligations of other agreements. The U.S. Model provision states generally that national treatment or MFN obligations undertaken by the Contracting States under any agreement other than the tax treaty and the General Agreement on Tariffs and Trade as applicable to trade in goods do not apply to a taxation measure, unless the competent authorities otherwise agree. Except as discussed above with respect to GATS, subparagraph 2(b) of the Convention provides that if there were overlap between Article 28 of the Convention and the national treatment or MFN obligations of any agreement, benefits would be available under both the Convention and that agreement. In the event of such overlap, to the extent benefits are available under that agreement that are not available under Article 28 of the Convention, a resident of a Contracting State is entitled to the benefits provided under the overlapping agreement.

ARTICLE 2

Article 2 of the Protocol modifies Article 4 (Resident) of the 1992 Convention by eliminating a special rule regarding the residence of estates and trusts. This rule is no longer necessary as the Protocol adopts a more general rule regarding fiscally transparent entities, found in a new paragraph 4 of Article 24 (Basis of Taxation) of the Convention. The new paragraph is discussed below in the Technical Explanation to Article 6 of the Protocol.

Although the general rule regarding the determination of residence has not been changed, subparagraph (b) of Paragraph I of the Understanding clarifies the application of the existing definition with respect to certain dual resident companies. If a company is a resident of one of the Contracting States under the domestic law of that State, but is treated as a resident of a third state under a treaty between that State and the third state, then it will not be treated as a resident of the Contracting State for purposes of the Convention. For example, if a company that is organized in the Netherlands is managed and controlled in the United Kingdom, both countries would treat the company as being a resident under its domestic laws. However, the treaty between the Netherlands and the United Kingdom assigns residence in such a case to the country in which the company's place of effective management is located. Assuming that, in this case, the place of effective management is the United Kingdom, the company would not qualify for benefits under the U.S.-Netherlands treaty because it is not subject to tax in the Netherlands as a resident of the Netherlands. The paragraph in the Understanding thus is consistent with the holding of Rev. Rul. 2004–76, 2004–31 I.R.B. 111.

ARTICLE 3

Paragraph (a) of Article 3 of the Protocol replaces Article 10 (Dividends) of the Convention. Article 10 provides rules for the taxation of dividends paid by a company that is a resident of one Contracting State to a beneficial owner that is a resident of the other Contracting State. The Article provides for full residence country taxation of such dividends and a limited source-State right to tax. Finally, the Article prohibits a State from imposing taxes on a company resident in the other Contracting State, other than a branch profits tax, on undistributed earnings.

Paragraph 1

The right of a shareholder's country of residence to tax dividends arising in the source country is preserved by paragraph 1, which permits a Contracting State to tax its residents on dividends paid to them by a company that is a resident of the other Contracting State.

Paragraph 2

The State of source also may tax dividends beneficially owned by a resident of the other State, subject to the limitations of paragraphs 2 and 3. Paragraph 2 generally limits the tax in the State of source on the dividend paid by a company resident in that State to 15 percent of the gross amount of the dividend. If, however, the beneficial owner of the dividend is a company that is a resident of the other State and that directly owns shares representing at least 10 percent of the voting power of the company paying the dividend, then the withholding tax in the State of source is limited to 5 percent of the gross amount of the dividend. Shares are considered voting shares if they provide the power to elect, appoint or replace any person vested with the powers ordinarily exercised by the board of directors of a U.S. corporation.

The benefits of paragraph 2 may be granted at the time of payment by means of reduced withholding at source. It also is consistent with the paragraph for tax to be withheld at the time of payment at full statutory rates, and the treaty benefit to be granted by means of a subsequent refund so long as refund procedures are applied in a reasonable manner.

The term "beneficial owner" is not defined in the Convention, and is, therefore, defined as under the internal law of the country imposing tax (i.e., the source country). The beneficial owner of the dividend for purposes of Article 10 is the person to which the dividend income is attributable for tax. purposes under the laws of the source State. Thus, if a dividend paid by a corporation that is a resident of one of the States (as determined under Article 4 (Resident)) is received by a nominee or agent that is a resident of the other State on behalf of a person that is not a resident of that other State, the dividend is not entitled to the benefits of this Article. However, a dividend received by a nominee on behalf of a resident of that other State would be entitled to benefits. These interpretations are confirmed by paragraph 12 of the Commentary to Article 10 of the OECD Model. See also paragraph 24 of the Commentary to Article 1 of the OECD Model.

Companies holding shares through fiscally transparent entities such as partnerships are considered for purposes of this paragraph to hold their proportionate interest in the shares held by the intermediate entity. As a result, companies holding shares through such entities may be able to claim the benefits of subparagraph (a) under certain circumstances. The lower rate applies when the company's proportionate share of the shares held by the intermediate entity meets the 10 percent threshold. Whether this ownership threshold is satisfied may be difficult to determine and often will require an analysis of the partnership or trust agreement.

Paragraph 3

Paragraph 3 provides exclusive residence-country taxation (i.e. an elimination of withholding tax) with respect to certain dividends distributed by a company that is a resident of one Contracting State to a resident of the other Contracting State. As described further below, this elimination of withholding tax is available with respect to certain inter-company dividends.

Subparagraph (a) of paragraph 3 provides for the elimination of withholding tax on dividends beneficially owned by a company that has owned directly 80 percent or more of the voting power of the company paying the dividend for the 12-month period ending on the date the dividend is declared.

Eligibility for the elimination of withholding tax provided by subparagraph (a) is subject to additional restrictions based on, but supplementing, the rules of Article 26 (Limitation on Benefits). These restrictions are necessary because of the increased pressure on the Limitation on Benefits tests resulting from the fact that the United States has relatively few treaties that provide for such elimination of withholding tax on inter-company dividends. The additional restrictions are intended to prevent companies from re-organizing in order to become eligible for the elimination of withholding tax in circumstances where the Limitation on Benefits provision does not provide sufficient protection against treaty-shopping.

For example, assume that ThirdCo. is a company resident in a third country that does not have a tax treaty with the United States providing for the elimination of withholding tax on inter-company dividends. ThirdCo owns directly 100 percent of the issued and outstanding voting stock of USCo, a U.S. company, and of DCo, a

Netherlands company. DCo is a substantial company that manufactures widgets; USCo distributes those widgets in the United States. If ThirdCo contributes to DCo all the stock of USCo, dividends paid by USCo to DCo would qualify for treaty bene fits under the active trade or business test of Paragraph 4 of Article 26. However, allowing ThirdCo to qualify for the elimination of withholding tax, which is not available to it under the third state's treaty with the United States (if any), would encourage treaty-shopping.

Accordingly, a company that meets the holding requirements described above still will qualify for the benefits of paragraph 3 only in certain circumstances. Under Article 10(3)(b), publicly traded companies and subsidiaries of publicly-traded companies will qualify for the elimination of withholding tax without meeting any additional requirements. Thus, a company that is a resident of the Netherlands and that meets the listing and trading requirements of Article 26(2)(c) will be entitled to the elimination of withholding tax, subject to the 12-month holding period requirement of Article 10(3).

In addition, under Article 10(3)(c), a company that is a resident of a Contracting State may also qualify for the elimination of withholding tax on dividends if it satisfies the derivative benefits test of paragraph 3 of Article 26. Thus, a Netherlands company that owns all of the stock of a U.S. corporation can qualify for the elimination ofwithholding tax if it is wholly-owned, for example, by a U.K. or a Mexican publicly-traded company that otherwise satisfies the requirements to be an "equivalent beneficiary". At this time, ownership by companies that are residents of other EU, EEA or NAFTA countries would not qualify the Netherlands company for benefits under this provision, as the United States does not have treaties that eliminate the withholding tax on inter-company dividends with any other of those countries. If the United States were to negotiate such treaties with more of those countries, residents of those countries could then qualify as equivalent beneficiaries for purposes of this provision.

The derivative benefits test may also provide benefits to U.S. companies receiving dividends from Netherlands subsidiaries, because of the effect of the Parent-Subsidiary Directive in the European Union. Under that directive, inter-company dividends paid within the European Union are free of withholding tax. Under subparagraph (g) of paragraph 8 of Article 26, that directive will also be taken into account in determining whether the owner of U.S. company receiving dividends from a Netherlands company is an "equivalent beneficiary". Thus, a. company that is a resident of a Member State of the European Union will, by definition, meet the requirements regarding equivalent benefits with respect to any dividends received by its U.S. subsidiary from a Netherlands company. For example, assume USCo is a wholly-owned subsidiary of ICo, an Italian publicly traded company. USCo owns all of the shares of DCo, a Netherlands company. If DCo were to pay dividends directly to ICo, those dividends would be exempt from withholding tax in the Netherlands by reason of the Parent-Subsidiary Directive, even though the tax treaty between Italy and the Netherlands otherwise would allow the Netherlands to impose a:withholding tax at the rate of 5 percent. If ICo meets the other conditions of subparagraph 8(f) of Article 26, it will be treated as an equivalent beneficiary by reason of subparagraph 8(g) of that Article.

A company also could qualify for the elimination of withholding tax pursuant to Article 10(3)(c) if it is owned by seven or fewer U.S. or Netherlands residents who fall within a limited category of "qualified persons." This rule would apply; for example, to certain Netherlands corporations that are closely-held by a few Netherlands resident individuals or charities.

The definition of "equivalent beneficiary" is also intended to ensure that certain joint ventures, not just wholly-owned subsidiaries, can qualify for benefits. For example, assume that the United States were to enter into a treaty with Country X, an EU, EEA or NAFTA country, that includes a provision identical to Article 10(3). USCo is 100 percent owned by DCo, a Netherlands company, which in turn is owned 49 percent by PCo, a Netherlands publicly-traded company, and 51 percent by XCo, a publicly-traded company that is resident in Country X In the absence of a special rule for interpreting derivative benefits provisions, each of the shareholders would be treated as owning only their proportionate share of the shares held by DCo. If that rule were applied in this situation, neither shareholder would be an equivalent beneficiary, since neither would meet the 80 percent ownership test with respect to USCo. However, since both PCo and XCo are residents of countries that have treaties with the United States that provide for elimination of withholding tax on intercompany dividends, it is appropriate to provide benefits to DCo in this case.

Accordingly, the definition of "equivalent beneficiary" includes a rule of application that is intended to ensure that such joint ventures qualify for the benefits of

Article 10(3). Under that rule, each of the shareholders is treated as owning shares with the same percentage of voting power as the shares held by DCo for purposes of determining whether it would be entitled to an equivalent rate of withholding tax. This rule is necessary because of the. high ownership threshold for qualification for the elimination of withholding tax on inter-company dividends.

A company that qualifies for the benefits of the Convention under a Limitation on Benefits provision other than the rules described above will qualify for the elimination of withholding tax on inter-company dividends only if it acquired shares representing 80 percent or more of the voting stock of the company paying the dividends prior to October 1, 1998, or it receives a determination from the competent authority with respect to Article 10(3). Accordingly, in the first example above, DCo will not qualify for the elimination of withholding tax on dividends unless it owned USCo before October 1, 1998. If it did own. USCo before October I, 1998, then it will continue to qualify for the elimination of withholding tax on dividends so long as it qualifies for benefits under at least one of the tests of Article 26. So, for example, if ThirdCo decides to get out of the widget business and sells its. stock in DCo to FWCo, a company that is resident in a country with which the United States does not have a tax treaty, DCo would continue to qualify for the elimination of withholding tax on dividends so long as it continues to meet the requirements of the active trade or business test of Article 26(4) or, possibly, the competent authority discretionary test of Article 26(7).

The result would be different under the “ownership-base erosion” test of Article 26(2)(f). For example, assume DCo is a passive holding company owned by Netherlands individuals, which was established in 1996 to hold the shares of USCo. DCo qualifies for the benefits of the Convention only under the ownership-base erosion test of Article 26(2)(0. If the Netherlands individuals sell their stock in DCo to FWCo, DCo would lose all the benefits accorded to residents of the Netherlands under the Convention (including the elimination .of withholding tax on dividends) because the company would no longer qualify for benefits under Article 26 (unless, of course, the U.S. competent authority were to grant benefits under Article 26(7)).

If a company does not qualify for the elimination of withholding tax under any of the foregoing objective tests, it may request a determination from the relevant competent authority pursuant to paragraph 7 of Article 26. Benefits will be granted with respect to an item of income if the competent authority of the Contracting State in which the income arises determines that the establishment, acquisition or maintenance of such resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention.

In making its determination under Article 26(7) with respect to income arising in the United States, the U.S. competent authority will consider the obligations imposed upon the Netherlands by its membership in the European Communities. In particular, the United States will have regard to any legal requirements for the facilitation of the free movement of capital among Member States of the European Communities. The competent authority will also consider the differing internal tax systems, tax incentive regimes and tax treaty practices of the relevant Member States.

For example, in the case above where DCo ceased to qualify for the elimination of withholding tax because it was acquired by FWCo, the competent authority would consider whether FWCo were a resident of a Member State of the European Communities. If it were, that would be a factor in favor of a determination that DCo is entitled to the benefits of the elimination of withholding tax on dividends. This would be particularly true if the U.S. business was a relatively small portion of the business acquired. However, that positive factor could be outweighed by negative factors. One negative factor could be a determination by the U.S. competent authority that FWCo benefited from a tax incentive regime that eliminated any domestic taxation. The competent authority would also consider facts that might indicate that an acquisition was not undertaken “under ordinary business conditions” but instead was undertaken to acquire the Netherlands-U.S. “bridge.” These might include the fact that the Netherlands company was acquired even though all or substantially all of the business activities acquired consisted of the U.S. business; the fact that existing U.S. operations were restructured in an attempt to benefit from the elimination of withholding tax on dividends; or the fact that FWCo was owned by residents of a country that is not a Member State of the European Communities. Finally, another significant negative factor would be if the U.S. competent authority faced difficulties in learning the identity of FWCo’s owners, such as an uncooperative taxpayer or legal barriers such as “economic espionage ” or other limitations on the effective exchange of information in the country of which FWCo is a resident.

Paragraph VIII of the Understanding establishes a hierarchy with respect to these tests. Any company that acquired the shares of the paying company after September 30, 1998, may request a discretionary ruling from the competent authority, unless it would qualify for benefits under subparagraphs 3(b) or 3(c). Thus, the competent authority could agree that a company may qualify for the elimination of withholding tax even if it satisfies Limitation on Benefits under the active conduct of a trade or business or the headquarters company test, or even if it does not satisfy any of the objective tests in Article 26. However, the competent authority will not give "comfort rulings" to companies that meet the requirements of another subparagraph of paragraph 3.

Paragraph 4

Paragraph 4 modifies in particular cases the maximum rates of withholding tax at source provided for in paragraphs 2 and 3.

Subparagraph (a) provides that dividends paid by a U.S. Regulated Investment Company ("RIC") or U.S. Real Estate Investment Trust ('REIT") or a Dutch beleggingsinstelling are not eligible for the 5 percent maximum rate of withholding tax in subparagraph (a) of paragraph 2 or the elimination of withholding tax of paragraph 3.Subparagraph (b) of paragraph 4 provides that the 15 percent maximum rate of withholding tax in subparagraph (b) of paragraph (2) shall apply for dividends paid by a RIC or a Dutch beleggingsinstelling (subject to the rule in subparagraph (c) regarding beleggingsinstellings that invest primarily in real estate).

Subparagraph (c) provides that the 15 percent withholding rate in subparagraph (b) of paragraph (2) shall apply for dividends paid by a REIT or a beleggingsinstelling that invests in real estate to the same extent as a REIT, provided certain conditions are met. First, the dividend may qualify for the 15 percent maximum rate if the person beneficially entitled to the dividend is an individual holding an interest of not more than 25 percent in the REIT or beleggingsinstelling. Second, the dividend may qualify for the 15 percent maximum rate if it is paid with respect to a class of stock that is publicly traded and the person beneficially entitled to the dividend is a person holding an interest of not more than 5 percent of any class of stock of the REIT or beleggingsinstelling. Third, the dividend may qualify for the 15 percent maximum rate if the person beneficially entitled to the dividend holds an interest in the REIT or beleggingsinstelling of 10 percent or less and the REIT or beleggingsinstelling is "diversified" (i.e., the gross value of no single interest in real property held by the REIT or beleggingsinstelling exceeds 10 percent of the gross value of the REIT's or beleggingsinstelling's total interest in real property). For purposes of this diversification test, foreclosure property is not considered an interest in real property, and a REIT or beleggingsinstelling holding a partnership interest is treated as owning its proportionate share of any interest in real property held by the partnership. Finally, the 15 percent rate will apply with respect to dividends paid by a REIT to a beleggingsinstelling or by a beleggingsinstelling to a RIC or REIT.

The restrictions set forth above are intended to prevent the use of these investment vehicles to gain inappropriate source-country tax benefits for certain shareholders resident in the other Contracting State. For example, a company resident in the Netherlands that wishes to hold a diversified portfolio of U.S. corporate shares could hold the portfolio directly and pay a U.S. withholding tax of 15 percent on all of the dividends that it receives. Alternatively, it could hold the same diversified portfolio by purchasing 10 percent or more of the interests in a RIC. If the RIC is a pure conduit, there may be no U.S. tax cost to interposing the RIC in the chain of ownership. Absent the special rule in paragraph 4, such use of the RIC could transform portfolio dividends, taxable in the United States under the Convention at 15 percent, into direct investment dividends subject to no or 5 percent withholding tax.

Similarly, a resident of the Netherlands directly holding U.S. real property would pay U.S. tax either at a 30 percent rate on the gross income or at graduated rates on the net income. As in the preceding example, by placing the real property in a REIT, the investor could transform real estate income into dividend income, taxable at the rates provided in Article 10, significantly reducing the U.S. tax that otherwise would be imposed. Paragraph 4 prevents this result and thereby avoids a disparity between the taxation of direct real estate investments and real estate investments made through REITconduits. In the cases where the rules provide for a maximum 15 percent rate of withholding tax, the holding in the REIT is not considered the equivalent of a direct holding in the underlying real property.

Paragraph 5

Paragraph 5 clarifies that the restrictions on source country taxation provided by paragraphs 2, 3 and 4 do not affect the taxation of the profits out of which the dividends are paid. The taxation by a Contracting State of the income of its resident companies is governed by the internal law of the Contracting State, subject to the provisions of paragraph 5 of Article 28 (Non-Discrimination).

Paragraph 6

Paragraph 6 provides a broad and flexible definition of the term "dividends." This paragraph has not been amended by the Protocol The definition is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined under the tax law of the state of source, including types of arrangements that might be developed in the future.

The term dividends includes income from shares, or other corporate rights that are not treated as debt under the law of the source State, that participate in the profits of the company. The term also includes income that is subjected. to the same tax treatment as income from shares by the law of the State of source. Thus, a constructive dividend that results from a non-arm's length transaction between a corporation and a related party is a dividend.

In the case of the United States, the term dividends includes amounts treated as a dividend under U.S. law upon the sale or redemption of shares or upon a transfer of shares in a reorganization. See, *e.g.*, Rev. Raul. 92–85, 1992–2 C.B. 69 (sale of foreign subsidiary's stock to U.S. sister company is a deemed dividend to extent of subsidiary's and sister's earnings and profits). Further, a distribution from a. U.S. publicly traded limited partnership, which is taxed as a corporation under U.S. law, is a dividend for purposes of Article 10. However, a distribution by a limited liability company is not characterized by the United States as a dividend and, therefore, is not a dividend for purposes of Article 10, provided the limited liability company is not taxable as a corporation under U.S. law.

Finally, a payment denominated as interest that is made by a thinly capitalized corporation may be treated as a dividend to the extent that the debt is recharacterized as equity under the laws of the source State. In the case of the United States, these rules include section 163(j) of the Internal Revenue Code of 1986 (the "Code").

The term dividends also includes, in the case of the Netherlands, income from profit sharing bonds, and, in the case of the United States, income from debt obligations that carry the right to participate in profits.

Paragraph 7

Paragraph 7 provides that the rules of paragraphs 1, 2, 3, and 4 do not apply with respect to dividends paid with respect to holdings that form part of the business property of a permanent establishment or fixed base situated in the source country. Such dividends will be taxed on a net basis using the rates and rules of taxation generally applicable to residents of the State in which the permanent establishment is located, as modified by the Convention. An example of dividends paid with respect to the business property of a permanent establishment would be dividends derived by a dealer in stock or securities from stock or securities that the dealer held for sale to customers. In such a case, Article 7 (Business Profits) applies with respect to business profits from a permanent establishment and Article 15 (Independent Personal Services) applies to income from the performance of personal services in an independent capacity from a fixed base.

In the case of a permanent establishment that once existed in the State but that no longer exists, the provisions of paragraph 7 also apply, by virtue of paragraph 3 of Article 24 (Basis of Taxation), as modified by paragraph (d) of Article 6 of this Protocol, to dividends that would be attributable to such a permanent establishment if it did exist in the year of payment or accrual.

Paragraph 8

A State's right to tax dividends paid by a company that is a resident of the other State is restricted by paragraph 8 to cases in which the dividends are paid to a resident of that State or are attributable to a permanent establishment in that State. Thus, a State may not impose a "secondary" withholding tax on dividends paid by a nonresident company out of earnings and profits from that State. In the case of the United States, paragraph 8, therefore, overrides the ability to impose taxes under sections 871 and 882(a) on dividends paid by foreign corporations that have a U.S. source under section 861(a)(2)(B).

The paragraph also restricts a State's right to impose corporate level taxes on undistributed profits, other than a branch profits tax. The accumulated earnings tax

and the personal holding company taxes are taxes covered in Article 2 (Taxes Covered). Accordingly, under the provisions of Article 7 (Business Profits), the United States may not impose those taxes on the income of a resident of the other State except to the extent that income is attributable to a permanent establishment in the United States. Paragraph 8 further confirms the restriction on the U.S. authority to impose those taxes. The paragraph does not restrict a State's right to tax its resident shareholders on undistributed earnings of a corporation resident in the other State. Thus, the U.S. authority to impose the foreign personal holding company tax, its taxes on subpart F income and on an increase in earnings invested in U.S. property, and its tax on income of a passive foreign investment company that is a qualified electing fund is in no way restricted by this provision.

Paragraph (b) of Article 3 provides updated cross-references in Article 25 (Methods of Elimination of Double Taxation).

Relation to Other Articles

Notwithstanding the foregoing limitations on source country taxation of dividends, the saving clause of paragraph 1 of Article 24 (General Scope) permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 6 of Article 25 (Methods of Elimination of Double Taxation), as if the Convention had not come into effect.

The benefits of this Article are also subject to the provisions of Article 26 (Limitation on Benefits). Thus, if a resident of the Netherlands is the beneficial owner of dividends paid by a U.S. company, the shareholder must qualify for treaty benefits under at least one of the tests of Article 26 in order to receive the benefits of this Article.

ARTICLE 4

Article 4 of the Protocol amends Article 11 (Branch Tax) of the Convention by inserting a new sentence at the end of paragraph 3. Paragraph 1 of Article 11 permits a Contracting State to impose a branch tax on the dividend equivalent amount of a company resident in the other Contracting State which derives business profits attributable to a permanent establishment located in the first-mentioned State or which derives income subject to tax on a net basis in the first-mentioned State under Article 6 (Income from Real Property) or Article 14 (Capital Gains).

Paragraph 3 of Article 11 of the 1992 Convention provides that the branch profits tax will not be imposed at a rate exceeding the five percent rate allowed by paragraph 2(a) of Article 10 (Dividends), ensuring parallel treatment for branches and subsidiaries. The new sentence added to paragraph 3 further ensures such parallel treatment by providing for an exemption from the branch profits tax under conditions that parallel those for the elimination of withholding tax on inter-company dividends. Pursuant to paragraph 3, the branch profits tax may not be imposed in the case of a company which, before October 1, 1998, was engaged in activities giving rise to profits attributable to a permanent establishment (whether or not the permanent establishment was actually profitable during that period) or to income or gains that are of a type that would be subject to the provisions of Article 6 or paragraphs 1 or 4 of Article 13. In addition, the branch profits tax may not be imposed in the case of a company which is a qualified person by reason of subparagraph (c) of paragraph 2 of Article 26 (Limitation on Benefits) (*i.e.*, a publicly-traded company) or a company that would be entitled to benefits with respect to dividends under paragraph 3 of Article 26. Finally, the branch profits tax does not apply to a company that has received a ruling from the competent authority pursuant to paragraph 7 of Article 26 with respect to the dividend equivalent amount.

Thus, for example, if a Netherlands company would be subject to the branch profits tax with respect to profits attributable to a U.S. branch and not reinvested in that branch, paragraph 3 may apply to eliminate the branch profits tax if that branch was established in the United States before October 1, 1998 and the other requirements of the Convention (*e.g.*, Limitation on Benefits) are met. If, by contrast, a Netherlands company that did not have a branch in the United States before October 1, 1998, takes over, after October 1, 1998, the activities of a branch belonging to a third party, then the branch profits tax would apply, unless the Netherlands company is a qualified person under subparagraph (c) of paragraph 2 of Article 26, or is entitled to benefits under paragraph 3, or paragraph 7 of that Article.

Moreover, if a branch that satisfied the requirements of paragraph 3 of Article 11 by reason of having been involved in activities in the other State before October 1, 1998 transfers assets to a newly- incorporated, wholly-owned company, the treaty shopping concerns described above do not exist. Accordingly, in that case, it is expected that the U.S. competent authority will exercise its discretion to treat the new

parent-subsidiary group as qualified for the elimination of withholding tax as well, so long as the Netherlands parent meets the other ownership requirements of paragraph 3 of Article 10 with respect to the subsidiary.

ARTICLE 5

Article 5 of the Protocol updates the Convention's rules regarding cross-border pension contributions by eliminating the current rule, found in paragraph 5 of Article 28 (Non-Discrimination) and replacing it with new paragraphs 7 through 11 of Article 19 (Pensions, Annuities, Alimony).

Paragraph 7

New paragraph 7 of Article 19 of the Convention provides that if a resident of a Contracting State is a member or beneficiary of, or a participant in, an exempt pension trust established in the other Contracting State, the State of residence will not tax the income of the exempt pension trust with respect to that resident until a distribution is made. Thus, for example, if a U.S. citizen contributes to a U.S. qualified pension plan while working in the United States and then establishes residence in the Netherlands, paragraph 7 prevents the Netherlands from taxing currently the plan's earnings and accretions with respect to that individual. When the resident receives a distribution from the pension fund, that distribution may be subject to tax in the State of residence, subject to paragraphs 1, 2 and 3 of Article 19 (Pensions, Annuities, Alimony). The paragraph also makes clear that the U.S. citizen will not be subject to tax if he rolls over the balance in one exempt pension trust into another U.S. fund that qualifies as an exempt pension trust.

Paragraph 8

New paragraph 8 of Article 19 of the Convention provides certain benefits with respect to cross-border contributions to an exempt pension trust, subject to the limitations of paragraph 9 of the Article. It is irrelevant for purposes of paragraph 8 whether the participant establishes residence in the State where the individual renders services (the "host State"). The provisions of paragraph 8 are similar to the provisions of the U.S. Model with respect to pension contributions.

Subparagraph (a) of paragraph 8 allows an individual who exercises employment or self-employment in a Contracting State to deduct or exclude from income in that Contracting State contributions made by or on behalf of the individual during the period of employment or self-employment to an exempt pension trust established in the other Contracting State. Thus, for example, if a participant in a U.S. qualified plan goes to work in the Netherlands, the participant may deduct or exclude from income in the Netherlands contributions to the U.S. qualified plan made while the participant works in the Netherlands. Subparagraph (a), however, applies only to the extent of the relief allowed by the host State (e.g., the Netherlands in the example) for contributions to an exempt pension trust established in that State.

Subparagraph (b) of paragraph 8 provides that, in the case of employment, accrued benefits and contributions by or on behalf of the individual's employer, during the period of employment in the host State, will not be treated as taxable income to the employee in that State. Subparagraph (b) also allows the employer a deduction in computing business profits in the host State for contributions to the plan. For example, if a participant in a U.S. qualified plan goes to work in the Netherlands, the participant's employer may deduct from its business profits in the Netherlands contributions to the U.S. qualified plan for the benefit of the employee while the employee renders services in the Netherlands.

As in the case of subparagraph (a), subparagraph (b) applies only to the extent of the relief allowed by the host State for contributions to pension funds established in that State. Therefore, where the United States is the host State, the exclusion of employee contributions from the employee's income under this paragraph is limited to elective contributions not in excess of the amount specified in section 402(g). Deduction of employer contributions is subject to the limitations of sections 415 and 404. The section 404 limitation on deductions is calculated as if the individual were the only employee covered by the plan.

Paragraph 9

Paragraph 9 limits the availability of benefits under paragraph 8. Under subparagraph (a) of paragraph 9, paragraph 8 does not apply to contributions to an exempt pension trust unless the participant already was contributing to the trust, or his employer already was contributing to the trust with respect to that individual, before the individual began exercising employment in the State where the services are performed (the "host State"). This condition would be met if either the employee or

the employer was contributing to an exempt pension trust that was replaced by the exempt pension trust to which he is contributing. The rule regarding successor trusts would apply if, for example, the employer has been taken over by a company that replaces the existing pension plan with its own plan, rolling membership in the old plan and assets in the old trust over into the new plan and trust.

In addition, under subparagraph (b) of paragraph 9, the competent authority of the host State must determine that the recognized plan to which a contribution is made in the other Contracting State generally corresponds to the plan in the host State. Paragraph XII of the Understanding provides that the term "exempt pension trust" includes those arrangements that are treated as exempt pension trusts for purposes of Article 35 (Exempt Pension Trusts). The United States and the Netherlands entered into a competent authority agreement regarding the types of plans in each jurisdiction that will qualify as exempt pension trusts. See Notice 2000–57, 2000–2 C.B 389, 2000–43 I.R.B. 389.

Paragraph 10

Paragraph 10 generally provides U.S. tax treatment for certain contributions by or on behalf of U.S. citizens resident in the Netherlands to exempt pension trusts established in the Netherlands that is comparable to the treatment that would be provided for contributions to U.S. qualified plans . Under subparagraph (a) of paragraph 10, a U.S. citizen resident in the Netherlands may exclude or deduct for U.S. tax purposes certain contributions to an exempt pension trust established in the Netherlands. Qualifying contributions generally include contributions made during the period the U.S. citizen exercises an employment in the Netherlands if expenses of the employment are borne by a Netherlands employer or Netherlands permanent establishment. Similarly, with respect to the U.S. citizen's participation in the Netherlands pension plan, accrued benefits and contributions during that period generally are not treated as taxable income in the United States.

The U.S. tax benefit allowed by paragraph 10, however, is limited to the lesser of the amount of relief allowed for contributions and benefits under a corresponding exempt pension trust established in the Netherlands and, under subparagraph (b), the amount of relief that would be allowed for contributions and benefits under a generally corresponding pension plan established in the United States.

Subparagraph (c) provides that the benefits an individual obtains under paragraph 10 are taken into account when determining that individual's eligibility for benefits under a pension plan established in the United States. Thus, for example, contributions to a Netherlands exempt pension trust may be taken into account in determining whether the individual has exceeded the annual limitation on contributions to an individual retirement account.

Under subparagraph (d), paragraph 10 does not apply to pension contributions and benefits unless the competent authority of the United States has agreed that' the pension plan established in the Netherlands generally corresponds to a pension plan established in the United States. As noted above, the United States and the Netherlands have agreedthat certain plans in each jurisdiction will qualify as exempt pension trusts. Since paragraph 10 applies only with respect to persons employed by a Netherlands employer or Netherlands permanent establishment, however, the relevant Netherlands plans are those that correspond to employer plans in the United States, and not those that correspond to individual plans.

Paragraph 11

Paragraph 11 provides that the Netherlands will apply the rules of paragraphs 7, 8, 9 and 10 only with respect to U.S. exempt pension trusts that will provide information and surety to the Netherlands with respect to participants in the trust. Under Netherlands law, when a Netherlands resident ceases to be a resident of the Netherlands, the Netherlands makes a "preserved assessment," which means a tax on the amount of the pension attributable to employment in the Netherlands is assessed but not collected. The assessment lasts for 10 years and the employee is required to give surety. If a lump sum distribution or premature withdrawal is made within that time period, the tax is collected.

In addition to the surety provided by the employee who ceases to be a resident, Netherlands pension funds also are required to provide surety or otherwise ensure that the beneficiaries of the plan are not able to avoid taxation by the Netherlands. Under the 1992 Convention, contributions to U.S. pension funds are deductible only if the pension fund corresponds to a Netherlands exempt pension trust. Accordingly, the rules regarding surety already apply to U.S. pension plans to the extent that an employee or employer wishes to deduct pension contributions to the U.S. plan. An explicit rule is needed in the Protocol because Paragraph XII of the Under-

standing provides that the term "exempt pension trust" includes those arrangements that are treated as exempt pension trusts for purposes of Article 35 (Exempt Pension Trusts). Without the rule in Article 11, U.S. funds arguably no longer would have been subject to the types of surety obligations and information requirements that apply to Netherlands funds.

The Netherlands recognizes that these rules, including in particular those that require surety from both the employee and the pension fund may be burdensome, however, and therefore has agreed, in Paragraph XIII of the Understanding, that the competent authorities should work together to develop less burdensome methods of complying with these rules.

Relation to other Articles

Subparagraph (c) of Article 6 of the Protocol adds paragraphs 7, 8 and 10 of Article 19 as exceptions to the saving clause of paragraph 1 of Article 24 (Basis of Taxation). Accordingly, a U.S. resident who is a beneficiary of a Netherlands pension plan will not be subject to tax in the United States on the earnings and accretions of a Netherlands exempt pension trust with respect to that U.S. resident. In addition, a U.S. resident may claim the benefits of paragraph 8 if he meets its conditions. Finally, U.S. citizens who are residents of the Netherlands will receive the benefits provided by paragraph 10 with respect to contributions made to exempt pension trusts established in the Netherlands.

ARTICLE 6

Article 6 of the Protocol makes several changes to Article 24 (Basis of Taxation) of the Convention.

The changes provided in paragraphs (a) and (b) modify paragraph 1 of Article 24 of the Convention which permits the United States to continue to tax as U.S. citizens former citizens (other than Netherlands nationals) whose loss of citizenship had as one of its principal purposes the avoidance of tax. To reflect 1996 amendments to U.S. tax law in this area, the Protocol extends this treatment to former long term residents whose loss of such status had as one of its principal purposes the avoidance of tax.

Section 877 of the Code applies to former citizens and long-term residents of the United States whose loss of citizenship or long-term resident status had as one of its principal purposes the avoidance of tax. Under section 877, the United States generally treats an individual as having a principal purpose to avoid tax if either of the following criteria exceed established thresholds: (a) the average annual net income tax of such individual for the period of 5 taxable years ending before the date of the loss of status, or (b) the net worth of such individual as of the date of the loss of status. The thresholds are adjusted annually for inflation. Section 877(c) provides certain exceptions to these presumptions of tax avoidance. The United States defines "long-term resident" as an individual (other than a U.S. citizen) who is a lawful permanent resident of the United States in at least 8 of the prior 15 taxable years. An individual is not treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country and the individual does not waive the benefits of such treaty applicable to residents of the foreign country.

The changes made by paragraph (c) and paragraph (d) are discussed above in connection with Article 5 of the Protocol and Article 3 of the Protocol, respectively.

As noted in the Technical Explanation of Article 2 of the Protocol, paragraph (e) of Article 6 updates the Convention's rules regarding fiscally transparent entities by adding a new paragraph 4 to Article 24 of the Convention. In general, paragraph 4 relates to entities that are not subject to tax at the entity level, such as partnerships and certain estates and trusts, as distinct from entities that are subject to tax, but with respect to which tax may be relieved under an integrated system. This paragraph applies to any . resident of a Contracting State who is entitled to income derived through an entity that is treated as fiscally transparent under the laws of either Contracting State. Entities falling under this description in the United States include partnerships, common investment trusts under section 584 and grantor trusts. This paragraph also applies to U.S. limited liability companies ("LLCs") that are treated as partnerships for U.S. tax purposes.

Under paragraph 4, an item of income, profit or gain derived by such a fiscally transparent entity will be considered to be derived by a resident of a Contracting State if a resident is treated under the taxation laws of that State as deriving the item of income. For example, if a Netherlands company pays interest to an entity

that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered derived by a resident of the United States only to the extent that the taxation laws of the United States treats one or more U.S. residents (whose status as U.S. residents is determined, for this purpose, under U.S. tax law) as deriving the interest for U.S. tax purposes. In the case of a partnership, the persons who are, under U.S. tax laws, treated as partners of the entity would normally be the persons whom the U.S. tax laws would treat as deriving the interest income through the partnership. Also, it follows that persons whom the United States treats as partners but who are not U.S. residents for U.S. tax purposes may not claim a benefit for the interest paid to the entity under the Convention, because they are not residents of the United States for purposes of claiming this treaty benefit. (If, however, the country in which they are treated as resident for tax purposes, as determined under the laws of that country, has an income tax convention with the Netherlands, they may be entitled to claim a benefit under that convention.) In contrast, if, for example, an entity is organized under U.S. laws and is classified as a corporation for U.S. tax purposes, interest paid by a Netherlands company to the U.S. entity will be considered derived by a resident of the United States since the U.S. corporation is treated under U.S. taxation laws as a resident of the United States and as deriving the income.

The same result obtains even if the entity is viewed differently under the tax laws of the Netherlands (*e.g.*, as not fiscally transparent in the first example above where the entity is treated as a partnership for U.S. tax purposes). Similarly, the characterization of the entity in a third country is also irrelevant, even if the entity is organized in that third country. The results follow regardless of whether the entity is disregarded as a separate entity under the laws of one jurisdiction but not the other, such as a single owner entity that is viewed as a branch for U.S. tax purposes and as a corporation for Netherlands tax purposes. These results also obtain regardless of where the entity is organized (*i.e.*, in the United States, in the Netherlands, or, as noted above, in a third country).

For example, income from U.S. sources received by an entity organized under the laws of the United States, which is treated for Netherlands tax purposes as a corporation and is owned by a Netherlands shareholder who is a Netherlands resident for Netherlands tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent.

These principles also apply to trusts to the extent that they are fiscally transparent in either Contracting State. For example, if X, a resident of the Netherlands, creates a revocable trust in the United States and names persons resident in a third country as the beneficiaries of the trust, X would be treated under U.S. law as the beneficial owner of income derived from the United States. In that case, the trust's income would be regarded as being derived by a resident of the Netherlands only to the extent that the laws of the Netherlands treat X as deriving the income for Netherlands tax purposes.

Under subparagraph (b) of Paragraph XIV of the Understanding, the competent authorities may agree to deviate from this general principle in cases where the characterization by the residence country is irrelevant to the taxation of the resident of that country. The Understanding provides the example of an exempt pension trust that is a resident of the Netherlands and that invests in the United States through a U.S. LLC. In that case, the fact that the United States views the LLC as fiscally transparent and the Netherlands views it as non-transparent is irrelevant to the taxation of the exempt pension trust, which would be exempt on the investment income that it receives through the LLC, even if the Netherlands viewed the LLC as fiscally transparent. The competent authorities reached such an agreement on March 23, 2003, as reported in Announcement 2003–21, 2003–17 I.R.B. 846.

Paragraph 4 is not an exception to the saving clause of paragraph 1. Accordingly, as confirmed by subparagraph (a) of Paragraph XIV of the Understanding, paragraph 4 does not prevent a Contracting State from taxing an entity that is treated as a resident of that State under its tax law. For example, if a U.S. LLC with Netherlands members elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, and will impose withholding tax, at the rate provided in Article 10, on dividends paid by the LLC, without regard to whether the Netherlands views the LLC as fiscally transparent.

ARTICLE 7

Article 7 of the Protocol replaces Article 26 (Limitation on Benefits) of the Convention.

Structure of the Article

Article 26 follows the form used in other recent U.S. income tax treaties. Paragraph 1 states the general rule that a resident of a Contracting State is entitled to benefits otherwise accorded to residents only to the extent that the resident satisfies the requirements of the Article and any other specified conditions for the obtaining of such benefits. Paragraph 2 lists a series of attributes of a resident of a Contracting State, any one of which suffices to make such resident a "qualified person" and thus entitled to all the benefits of the Convention. Paragraph 3 provides a so-called "derivative benefits" test under which certain categories of income may qualify for benefits. Paragraph 4 sets forth the active trade or business test, under which a person not entitled to benefits under paragraph 2 may nonetheless be granted benefits with regard to certain types of income. Paragraph 5 provides that a resident of one of the Contracting States is entitled to all the benefits of the Convention if that person functions as a recognized headquarters company for a multinational corporate group. Paragraph 6 provides for limited "derivative benefits" for shipping and air transport income. Paragraph 7 provides that benefits may also be granted if the competent authority of the State from which the benefits are claimed determines that it is appropriate to grant benefits in that case. Paragraph 8 defines the terms used specifically in this Article.Each of the substantive provisions of Article 26 states that benefits shall be granted only if the resident of a Contracting State satisfies any other specified conditions for claiming benefits. This means, for example, that a publicly-traded company that satisfies the conditions of subparagraph 2(c) will be eligible for the elimination of withholding tax on dividends at source only if it also owns 80 percent or more of the voting power of the paying company and satisfies the 12-month holding period requirement of paragraph 3 of Article 10, and satisfies any other conditions specified in Article 10 or any other articles of the Convention.

Paragraph 1

Paragraph 1 provides that, except as otherwise provided, a resident of a Contracting State will be entitled to all the benefits of the Convention otherwise accorded to residents of a Contracting State only if the resident is a "qualified person" as defined in paragraph 2 of Article 26.

The benefits otherwise accorded to residents under the Convention include all limitations on source-based taxation under Articles 6 through 23 and 27, the treaty based relief from double taxation provided by Article 25 (Methods of Elimination of Double Taxation), and the protection afforded to residents of a Contracting State under Article 28. (Non-Discrimination). Some provisions do not require that a person be a resident in order to enjoy the benefits of those provisions. Article 29 (Mutual Agreement Procedure) is not limited to residents of the Contracting States, and Article 33 (Diplomatic Agents and Consular Officers) applies to diplomatic agents or consular officials regardless of residence. Article 26 accordingly does not limit the availability of treaty benefits under these provisions.

Article 26 and the anti-abuse provisions of domestic law complement each other, as Article 26 effectively determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while domestic anti-abuse provisions (e.g., business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance. Thus, internal law principles of the source Contracting State may be applied to identify the beneficial owner of an item of income, and Article 26 then will be applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income.

Paragraph 2

Paragraph 2 has six subparagraphs, each of which describes a category of residents that constitute "qualified persons" and thus are entitled to all benefits of the Convention. It is intended that the provisions of paragraph 2 will be self-executing. Claiming benefits under paragraph 2 does not require advance competent authority ruling or approval. The tax authorities may, of course, on review, determine that the taxpayer has improperly interpreted the paragraph and is not entitled to the benefits claimed.

Individuals—Subparagraph 2(a)

Subparagraph (a) provides that individual residents of a Contracting State will be entitled to all the benefits of the Convention. If such an individual receives income as a nominee on behalf of a third country resident, benefits may be denied under the applicable articles of the Convention by the requirement that the beneficial owner of the income be a resident of a Contracting State.

Governments—Subparagraph 2(b)

Subparagraph (b) provides that the Contracting States and any political subdivision or local authority thereof will be entitled to all the benefits of the Convention.

Publicly Traded Corporations—Subparagraph 2(c)

Subparagraph (c) applies to two categories of companies: publicly traded companies and subsidiaries of publicly traded companies. A company resident in a Contracting State is entitled to all the benefits of the Convention under clause (i) of subparagraph (c) if the principal class of its shares, and any disproportionate class of shares, is listed on a recognized U.S. or Netherlands stock exchange and is regularly traded on one or more recognized stock exchanges, unless the company has no substantial presence in the State in which it is a resident, as described below.

The term "recognized stock exchange" is defined in subparagraph (a) of paragraph 8. It includes the NASDAQ System and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934. It also includes the Amsterdam Stock Exchange and any other stock exchange subject to regulation by the Authority for the Financial Markets (or its successor) in the Netherlands. Paragraph XXVII of the Understanding specifies that, for these purposes, certain exchanges that are part of Euronext will be considered to be subject to regulation by the Authority for the Financial Markets. The term also includes the Irish Stock Exchange, the Swiss Stock Exchange, the stock exchanges of Brussels, Frankfurt, Hamburg, Johannesburg, London, Madrid, Milan, Paris, Stockholm, Sydney, Tokyo, Toronto, and Vienna, and any other stock exchange agreed upon by the competent authorities of the Contracting States.

The term "principal class of shares" is defined in subparagraph (b) of paragraph 7. Clause (i) defines the term to mean the ordinary or common shares of the company representing the majority of the aggregate voting power and value of the company. If the company does not have a class of ordinary or common shares representing the majority of the aggregate voting power and value of the company, then the "principal class of shares" is that class or any combination of classes of shares that represents, in the aggregate, a majority of the voting power and value of the company. In addition, clause (ii) of subparagraph (b) defines the term "shares" to include depository receipts for shares or trust certificates for shares.

The term "disproportionate class of shares" is defined in subparagraph (c) of paragraph 8. A company has a disproportionate class of shares if it has outstanding a class of shares which is subject to terms or other arrangements that entitle the holder to a larger portion of the company's income, profit, or gain in the other Contracting State than that to which the holder would be entitled in the absence of such terms or arrangements. Thus, for example, a company resident in the Netherlands meets the test of subparagraph (c) of paragraph 8 if it has outstanding a class of "tracking stock" that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States.

A company whose principal class of stock is publicly traded will nevertheless not qualify for benefits under subparagraph (c) of paragraph 2 if it has a disproportionate class of shares that is not publicly traded. The following example illustrates this result.

> *Example.* DCo is a corporation resident. in the Netherlands. DCo has two classes of shares: Common and Preferred. The Common shares are listed and regularly traded on the Amsterdam Stock Exchange. The Preferred shares have no voting rights and are entitled to receive dividends equal in amount to interest payments that DCo receives from unrelated borrowers in the United States. The Preferred shares are owned entirely by a single investor that is a resident of a country with which the United States does not have a tax treaty. The Common shares account for more than 50 percent of the value of DCo and for 100 percent of the voting power. Because the owner of the Preferred shares is entitled to receive payments corresponding to the U.S. source interest income earned by DCo, the Preferred shares are a disproportionate class of shares. Because the Preferred shares

are not regularly traded on a recognized stock exchange, DCo will not qualify for benefits under subparagraph (c) of paragraph 2.

A class of shares will be "regularly traded" in a taxable year, under subparagraph (h) of paragraph 8, if the aggregate number of shares of that class traded on one or more recognized exchanges during the twelve months ending on the day before the beginning of that taxable year is at least six percent of the average number of shares outstanding in that class during that twelve-month period. For this purpose, Paragraph XXVII of the Understanding provides that, if a class of shares was not listed on a recognized stock exchange during this twelve-month period, the class of shares will be treated as regularly traded only if the class meets the aggregate trading requirements for the taxable period in which the income arises. Trading on one or more recognized stock exchanges may be aggregated for purposes of meeting the "regularly traded" standard of subparagraph (h). For example, a U.S. company could satisfy the definition of "regularly traded" through trading, in whole or in part, on a recognized stock exchange located in the Netherlands or certain third countries. Authorized but unissued shares are not considered for purposes of subparagraph (h).

The Protocol adds a new requirement to the publicly-traded company test intended to ensure that there is an adequate connection between a public company and its State of residence. A company that is regularly traded on one or more recognized stock exchanges will not qualify for treaty benefits under the publicly-traded company test if it has no "substantial presence" in its country of residence.

There are two components to the "no substantial presence" test. The first component determines whether public trading establishes a sufficient nexus to the State of residence of the company. The second component provides companies with an alternative means for establishing that nexus, by determining whether the company's "primary place of management and control" is in the State of which the company is a resident.

There are two elements to the public trading component of the "no substantial presence" test. The first element compares trading in the State of which the company is not a resident to trading in the company's primary economic zone. For the United States, the primary economic zone is the NAFTA countries and for the Netherlands, the primary economic zone is the European Economic Area and the European Union. Thus, in the case of a Netherlands company, if more trading in its stock takes place on recognized stock exchanges in the United States than on recognized stock exchanges in the EEA and the EU, it will fail the trading component. The second element of the trading component compares trading within the company's primary economic zone with worldwide trading. If the stock of a company is not traded in its primary economic zone at all, or if trading in its primary economic zone constitutes less than 10 percent of total worldwide trading, the company will fail the trading component. Accordingly, a Netherlands company that met the "regularly traded" requirement of the public company test primarily through trading on the Johannesburg, Sydney, Tokyo, or Toronto stock exchanges might fail tie trading component.

However, even if a company fails the public trading component of the "no substantial presence" test, it may still qualify for benefits under subparagraph (c) of paragraph 2 if the company's primary place of management and control is in the country of which it is a resident. This test should be distinguished from the "place of effective management" test which is used in the OECD Model and by many other countries to establish residence. In some cases, the place of effective management test has been interpreted to mean the place where the board of directors meets. By contrast, the primary place of management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised. The company's primary place of management and control will be located in the State in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries) in that State than in the other State or any third state, and the staffs that support the management in making those decisions are also based in that State.

Paragraph XXVI of the Understanding provides guidance regarding the persons who are to be considered "executive officers and senior management employees". In most cases, it will not be necessary to look beyond the executive board in the case of a Netherlands company or the executives who are members of the board of directors (the "inside directors") in the case of a U.S. company. That will not always be the case, however, and the Understanding makes clear that the relevant persons may be employees of subsidiaries if they make the strategic, financial and operational policy decisions. Moreover, if there are special voting arrangements that re-

sult in certain board members making certain decisions without the participation of other board members, that fact would be taken into account as well.

The following example illustrates the principles of Paragraph XXVI:

> *Example.* NCo is a publicly-traded Netherlands corporation that, along with its subsidiaries, is engaged in the music business. NCo has 50 subsidiaries located in countries around the world, organized under regional holding companies. The local subsidiaries and their regional holding companies are responsible for developing local artists; in most cases, those artists will sell recordings only in their local markets although NCo will choose one or two artists each year to promote globally. The exceptions to this are the U.S. and U.K. subsidiaries of NCo, many of whose artists achieve success worldwide. Because the subsidiaries are primarily responsible for developing their local markets, NCo allows the managers of the subsidiaries substantial autonomy to make significant business decisions, such as the principal artists to sign and how to market and promote them. NCo's substantial Asian operations are managed by employees in its Japanese holding company. Like many Netherlands companies, NCo has both an executive board and a supervisory board. The supervisory board does not participate in decisions before they are made but, pursuant to statute, has oversight responsibilities with respect to the executive board. The members of NCo's executive board include the chief executive officer and chief operating officer of NCo, and the chief executive officers of its U.S. holding company, its U.K. holding company, and its Japanese holding company. On these facts, therefore, the executives most responsible for guiding NCo's global business are members of the executive board. Accordingly, it will not be necessary to look beyond the executive board in applying the management factor.

Paragraph XXVI also includes a special rule for dealing with integrated corporate groups, where staffs located in two different countries support the management of two publicly traded companies. The special rule only applies if the other state in which the staffs are located is in the primary economic zone of the Netherlands and has a tax treaty with the United States that would provide equivalent benefits as the Convention. Thus, at the moment, this rule is limited to integrated corporate groups consisting of a Netherlands publicly traded company and a UK publicly traded company and their direct and indirect subsidiaries.

A company resident in a Contracting State is entitled to all the benefits of the Convention under clause (ii) of subparagraph (c) of paragraph 2 if five or fewer publicly-traded companies described in clause (i) are the direct or indirect owners of at least 50 percent of the aggregate vote and value of the company's shares (and at least 50 percent of any disproportionate class of shares). If the publicly-traded companies are indirect owners, however, each of the intermediate companies must be a resident of one of the Contracting States. Thus, for example, a Netherlands company, all the shares of which are owned by another Netherlands company, would qualify for benefits under the Convention if the principal class of shares of the Netherlands parent company were listed on the Amsterdam Stock Exchange and regularly traded on the London stock exchange. However, the Netherlands company would not qualify for benefits under clause (ii) if the publicly traded parent company were a resident of Ireland, not of the United States or the Netherlands. Furthermore, if the Netherlands parent indirectly owned the Netherlands company through a chain of subsidiaries, each such subsidiary in the chain, as an intermediate owner, must be a resident of the United States or the Netherlands for the Netherlands company to meet the test in clause (ii).

Exempt Pension Trusts—Subparagraph 2(d)

An exempt pension trust is entitled to all the benefits of the Convention if, as of the close of the end of the prior taxable year, more than 50 percent of the beneficiaries, members or participants of the exempt pension trust are individuals resident in either Contracting State or if the organization sponsoring the pension trust is a qualified person. For purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the exempt pension trust.

Tax Exempt Organizations—Subparagraph 2(e)

A tax-exempt organization other than an exempt pension trust is entitled to all the benefits of the Convention, without regard to the residence of its beneficiaries or members. Entities qualifying under this subparagraph are those that generally are exempt from tax in their Contracting State of residence and that are organized

and operated exclusively to fulfill religious, charitable, educational, scientific, artistic, cultural, or public purposes.

Ownership/Base Erosion—Subparagraph 2(f)

Subparagraph 2(f) provides an additional test that applies to any form of legal entity that is a resident of a Contracting State. The test provided in subparagraph (f), the so-called ownership and base erosion test, is a two-part test. Both prongs of the test must be satisfied for the resident to be entitled to benefits under subparagraph 2(f). A company that would be a qualified person under subparagraph 2(c) but for the fact that it has no substantial presence in its State of residence may not qualify for benefits under subparagraph 2(f).

The ownership prong of the test, under clause. (i), requires that 50 percent or more of the aggregate voting power and value of the person (and 50 percent or more of any disproportionate class of shares) be owned directly or indirectly on at least half the days of the person's taxable year by persons who are themselves qualified persons under certain other tests of paragraph 2—subparagraphs (a), (b), (d) or (e), or clause (i) of subparagraph (c).

Trusts may be entitled to benefits under this provision if they are treated as residents under Article 4 (Resident) and they otherwise satisfy the requirements of this subparagraph. For purposes of this subparagraph, the beneficial interests in a trust will be considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust. The interest of a remainder beneficiary will be equal to 100 percent less the aggregate percentages held by income beneficiaries. A beneficiary's interest in a trust will not be considered to be owned by a person entitled to benefits under the other provisions of paragraph 2 if it is not possible to determine the beneficiary's actuarial interest. Consequently, if it is not possible to determine the actuarial interest of the beneficiaries in a trust, the ownership test under clause i) cannot be satisfied, unless all possible beneficiaries are persons entitled to benefits under the other subparagraphs of paragraph 2.

The base erosion prong of clause (ii) of subparagraph (f) is not satisfied with respect to a person if 50 percent or more of the person's gross income for the taxable year is paid or accrued to a person or persons who are not residents of either Contracting State, in the form of payments deductible for tax purposes in the payer's State of residence. For this purpose, Paragraph XV of the Understanding states that the term "gross income" means total revenues derived by a resident of a Contracting State from its principal operations, less the direct costs of obtaining such revenues. In the case of the United States, the term "gross income" has the same meaning as such term in section 61 of the Code and the regulations thereunder.

To the extent they are deductible from the taxable base, trust distributions are deductible payments, However, depreciation and amortization deductions, which do not represent payments or accruals to other persons, are disregarded for this purpose. Deductible payments also do not include arm's length payments in the ordinary course of business for services or tangible property or with respect to financial obligations to banks that are residents of either Contracting State or that have a permanent establishment in either Contracting State to which the payment is attributable.

Paragraph 3

Paragraph 3 sets forth a derivative benefits test that is potentially applicable to all treaty benefits, although the test is applied to individual items of income. In general, a derivative benefits test entitles the resident of a Contracting State to treaty benefits if the owner of the resident would have been entitled to the same benefit had the income in question flowed directly to that owner. To qualify under this paragraph, the company must meet an ownership test and a base erosion test.

Subparagraph (a) sets forth the ownership test. Under this test, seven or fewer equivalent beneficiaries must own shares representing at least 95 percent of the aggregate voting power and value of the company. Ownership may be direct or indirect. The term "equivalent beneficiary" is defined in subparagraph (f) of paragraph 8. This definition may be met in two alternative ways, the first of which has two requirements.

Under the first alternative, a person may be an equivalent beneficiary because it is entitled to equivalent benefits under a treaty between the country of source and the country in which the person is a resident. This alternative has two requirements.

The first requirement is that the person must be a resident of a Member State of the European Community, a European Economic Area state, or a party to the North American Free Trade Agreement (collectively, "qualifying States").

The second requirement of the definition of “equivalent beneficiary” is that the person must be entitled to equivalent benefits under an applicable treaty. To satisfy the second requirement, the person must be entitled to all the benefits of a comprehensive treaty between the Contracting State from which benefits of the Convention are claimed and a qualifying State under provisions that are analogous to the rules in Paragraph 2 regarding individuals, qualified governmental entities, publicly-traded companies or entities, and tax-exempt organizations. Moreover, if the treaty in question does not have a comprehensive limitation. on benefits article, this requirement only is met if the person would be a “qualified person” under the tests in Paragraph 2 applicable to individuals, qualified governmental entities, publicly-traded companies or entities, and tax-exempt organizations.

In order to satisfy the additional requirement necessary to qualify as an “equivalent beneficiary” under paragraph 8(f)(i)(B) with respect to dividends, interest, royalties or branch tax, the person must be entitled to a rate of withholding tax that is at least as low as the withholding tax rate that would apply under the Convention to such income. Thus, the rates to be compared are: (1) the rate of withholding tax that the source State would have imposed if a qualified resident of the other Contracting State was the beneficial owner of the income; and (2) the rate of withholding tax that the source State would have imposed if the third State resident received the income directly from the source State. For example, USCo is a wholly owned subsidiary of DCo, a company resident in the Netherlands. DCo is wholly owned by ICo, a corporation resident in Italy. Assuming DCo satisfies the requirements of paragraph 3 of Article 10 (Dividends), DCo would be eligible for the elimination of dividend withholding tax. The dividend withholding tax rate in the treaty between the United States and Italy is 5 percent. Thus, if ICo received the dividend directly from USCo, ICo would have been subject to a 5 percent rate of withholding tax on the dividend. Because ICo would not be entitled to a rate of withholding tax that is at least as low as the rate that would apply under the Convention to such income (*i.e.*, zero), ICo is not an equivalent beneficiary within the meaning of paragraph 8(f)(i) of Article 26 with respect to the elimination of withholding tax on dividends.

Subparagraph 8(g) provides a special rule to take account of the fact that withholding taxes on many inter-company dividends, interest and royalties are exempt within the European Union by reason of various EU directives, rather than by tax treaty. If a U.S. company receives such payments from a Netherlands company, and that U.S. company is owned by a company resident in a Member State of the European Union that would have qualified for an exemption from withholding tax if it had received the income directly, the parent company will be treated as an equivalent beneficiary. This rule is necessary because many EU member countries have not re-negotiated their tax treaties to reflect the rates applicable under the directives.

Paragraph XVII of the Understanding illustrates the “all the benefits” requirement. The requirement that a person be entitled to “all the benefits” of a comprehensive tax treaty eliminates those persons that qualify for benefits with respect to only certain types of income. Accordingly, the fact that a French parent of a Netherlands company is engaged in the active conduct of a trade or business in France and therefore would be entitled to the benefits of the U.S.-France treaty if it received dividends directly is not sufficient for purposes of this paragraph. Further, the French company cannot be an equivalent beneficiary if it qualifies for benefits only with respect to certain income as a result of a “derivative benefits” provision in the U.S.-France treaty. However, it would be possible to look through the French company to its parent company to determine whether the parent company is an equivalent beneficiary.

The second alternative for satisfying the “equivalent beneficiary” test is available only to residents of one of the two Contracting States. U.S. or Netherlands residents who are qualified persons by reason of subparagraphs (a), (b), (c)(i), (d), or (e) of paragraph 2 are equivalent beneficiaries for purposes of the relevant tests in Article 26. Thus, a Netherlands individual will be an equivalent beneficiary without regard to whether the individual would have been entitled to receive the same benefits if it received the income directly. A resident of a third country cannot be a “qualified person” by reason of those paragraphs or any other rule of the treaty, and therefore do not qualify as equivalent beneficiaries under this alternative. Thus, a resident of a third country can be an equivalent beneficiary only if it would have been entitled to equivalent benefits had it received the income directly.

The second alternative was included in order to clarify that ownership by certain residents of a Contracting State would not disqualify a U.S. or Netherlands company under this paragraph. Thus, for example, if 90 percent of a Netherlands com-

pany is owned by five companies that are resident in member states of the European Union who satisfy the requirements of clause (i), and 10 percent of the Netherlands company is owned by a U.S. or Netherlands individual, then the Netherlands company still can satisfy the requirements of subparagraph (a) of paragraph 3.

Subparagraph (b) sets forth the base erosion test. A company meets this base erosion test if less than 50 percent of its gross income for the taxable period is paid or accrued, directly or indirectly, to a person or persons who are not equivalent beneficiaries in the form of payments deductible for tax purposes in company's State of residence. This test is the same as the base erosion test in clause (ii) of subparagraph (f) of paragraph 2, except that deductible payments made to equivalent beneficiaries, rather than amounts paid to residents of a Contracting State, are not counted against a company for purposes of determining whether the company exceeded the 50 percent limit.

As in the case of base erosion test in subparagraph (f) of paragraph 2, deductible payments in subparagraph (b) of paragraph 3 also do not include arm's length payments in the ordinary course of business for services or tangible property or with respect to financial obligations to banks that are residents of either Contracting State or that have a permanent establishment in either Contracting State to which the payment is attributable.

Under the 1992 Convention, the derivative benefits provision had somewhat different requirements. The test required that 30 percent of the shares of the company claiming benefits be owned by Netherlands residents, but only 70 percent of the shares had to be owned by equivalent beneficiaries (including Netherlands residents). It is possible that some companies would qualify for benefits under the prior test, but not under the provisions of paragraph 3, and vice versa. Since satisfaction of the prior test demonstrates a close connection to the Netherlands, it remains a valid objective test. Accordingly, subparagraph (a) of Paragraph XXIV of the Understanding provides that a company will be granted the benefits of the Convention pursuant to the competent authority discretion provision in cases where more than 30 percent of vote and value of the company's shares are owned by residents of a Contracting State that are described in subparagraph 8(f)(ii) and more than 70 percent of the shares (and at least 50 percent of any disproportionate class of shares) is owned by seven or fewer equivalent beneficiaries, provided that the base erosion test has been met.

Paragraph 4

Paragraph 4 sets forth a test under which a resident of a Contracting State that is not a "qualified person" under paragraph 2 may receive treaty benefits with respect to certain items of income that are connected to an active trade or business conducted in its State of residence.

Subparagraph (a) sets forth the general rule that a resident of a Contracting State engaged in the active conduct of a trade or business in that State may obtain the benefits of the Convention with respect to an item of income, profit, or gain derived in the other Contracting State. The item of income, profit, or gain, however, must be derived in connection with or incidental to that trade or business.

The term "trade or business" is not defined in the Convention. Pursuant to paragraph 2 of Article 3 (General Definitions), when determining whether a resident of the Netherlands is entitled to the benefits of the Convention under paragraph 4 of this Article with respect to an item of income derived from sources within the United States, the United States will ascribe to this term the meaning that it has under the law of the United States. Accordingly, the U.S. competent authority will refer to the regulations issued under section 367(a) for the definition of the term "trade or business." In general, therefore, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The business of making or managing investments for the resident's own account will be considered to be a trade or business only when part of banking, insurance or securities activities conducted by a bank, an insurance company, or a registered securities dealer. Such activities conducted by a person other than a bank, insurance company or registered securities dealer will not be considered to be the conduct of an active trade or business, nor would they be considered to be the conduct of an active trade or business if conducted by a bank, insurance company or registered securities dealer but not as part of the company's banking, insurance or dealer business.

For this purpose, Paragraph XX of the Understanding states that a bank will be considered to be engaged in the active conduct of a trade or business only if it regularly accepts deposits from the public and makes loans to the public. Furthermore, an insurance company only is engaged in the active conduct of an insurance business if its gross income consists primarily of insurance or reinsurance premiums and investment income attributable to such premiums.

Because a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in an active trade or business for purposes of subparagraph (a). It may, however, qualify for benefits if it meets the requirements of paragraph 5.

Paragraph XIX of the Understanding provides that an item of income is derived in connection with a trade or business if the income-producing activity in the State of source is a line of business that "forms a part of" or is "complementary" to the trade or business conducted in the State of residence by the income recipient.

A business activity generally will be considered to form part of a business activity conducted in the State of source if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services. The notes clarify that the line of business in the State of residence may be upstream, downstream, or parallel to the activity conducted in the State of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the State of source, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the State of source.

Example 1. USCo is a corporation resident in the United States. USCo is engaged in an active manufacturing business in the United States. USCo owns 100 percent of the shares of DCo, a company resident in the Netherlands. DCo distributes USCo products in the Netherlands. Because the business activities conducted by the two corporations involve the same products, DCo's distribution business is considered to form a part of USCo's manufacturing business.

Example 2. The facts are the same as in Example 1, except that USCo does not manufacture. Rather, USCo operates a large research and development facility in the United States that licenses intellectual property to affiliates worldwide, including DCo. DCo and other USCo affiliates then manufacture and market the USCo-designed products in their respective markets. Because the activities conducted by DCo and USCo involve the same product lines, these activities are considered to form a part of the same trade or business.

For two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Where more than one trade or business is conducted in the State of source and only one of the trades or businesses forms a part. of or is complementary to a trade or business conducted in the State of residence, it is necessary to identify the trade or business to which an item of income is attributable. Royalties generally will be considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends will be deemed to be derived first out of earnings and profits of the treaty benefited trade or business, and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

Example 3. Americair is a corporation resident in the United States that operates an international airline. DSub is a wholly-owned subsidiary of Americair resident in the Netherlands. DSub operates a chain of hotels in the Netherlands that are located near airports served by Americair flights. Americair frequently sells tour packages that include air travel to the Netherlands and lodging at DSub hotels. Although both companies are engaged in the active conduct of a trade or business, the businesses of operating a chain of hotels and operating an airline are distinct trades or businesses. Therefore DSub's business does not form a part of Americair's business. However, DSub's business is considered to be complementary to Americair's business because they are part of the same overall industry (travel), and the links between their operations tend to make them interdependent.

Example 4. The facts are the same as in Example 3, except that DSub owns an office building in the Netherlands instead of a hotel chain. No part

of Americair's business is conducted through the office building. DSub's business is not considered to form a part of or to be complementary to Americair's business. They are engaged in distinct trades or businesses in separate industries, and there is no economic dependence between the two operations.

Example 5. USFlower is a company resident in the United States. USFlower produces and sells flowers in the United States and other countries. USFlower owns all the shares of DHolding, a corporation resident in the Netherlands. DHolding is a holding company that is not engaged in a trade or business. DHolding owns all the shares of three corporations that are resident in the Netherlands: DFlower, DLawn, and DFish. DFlower distributes USFlower flowers under the USFlower trademark in the Netherlands. DLawn markets a line of lawn care products in the Netherlands under the USFlower trademark. In addition to being sold under the same trademark, DLawn and DFlower products are sold in the same stores and sales of each company's products tend to generate increased sales of the other's products. DFish imports fish from the United States and distributes it to fish wholesalers in the Netherlands. For purposes of paragraph 4, the business of DFlower forms a part of the business of USFlower, the business of DLawn is complementary to the business of USFlower, and the business of DFish is neither part of nor complementary to that of USFlower.

Paragraph XIX of the Understanding also provides that an item of income derived from the State of source is "incidental to" the trade or business carried on in the State of residence if production of the item facilitates the conduct of the trade or business in the State of residence. An example of incidental income is the temporary investment of working capital of a person in the State of residence in securities issued by persons in the State of source.

Subparagraph (b) of paragraph 4 states a further condition to the general rule in subparagraph (a) in cases where the trade or business generating the item of income in question is carried on either by the person deriving the income or by any associated enterprises. Subparagraph (b) states that the trade or business carried on in the State of residence, under these circumstances, must be substantial in relation to the activity in the State of source. Paragraph XXII of the Understanding elaborates on the purpose and application of the substantiality requirement. The requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (i.e., activities that have little economic cost or effect with respect to the company business as a whole).

The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of fir trades or businesses in each Contracting State (measured by reference to asset values, income and payroll expenses), the nature of the activities performed in each Contracting State, and the relative contributions made to that trade or business in each Contracting State. In any case, in making each determination or comparison, due regard will be given to the relative sizes of the U.S. and Netherlands economies.

In addition to this subjective rule, Paragraph XXII of the Understanding provides a safe harbor under which the trade or business of the income recipient may be deemed to be substantial based on three ratios that compare the size of the recipient's activities to those conducted in the other State with respect to the preceding taxable year, or the average of the preceding three years. The three ratios compare: (i) the value of the assets in the recipient's State to the assets used in the other State; (ii) the gross income derived in the recipient's State to the gross income derived in the other State; and (iii) the payroll expense in the recipient's State to the. payroll expense in the other State. The average of the three ratios must exceed 10 percent, and each individual ratio must equal at least 7.5 percent. For purposes of this test, if the income recipient owns, directly or indirectly, less than 100 percent of the activity conducted in either State, only its proportionate share of the activity will be taken into account.

The determination in subparagraph (b) also is made separately for each item of income derived from the State of source. It therefore is possible that a person would be entitled to the benefits of the Convention with respect to one item of income but not with respect to another. If a resident of a Contracting State is entitled to treaty benefits with respect to a particular item of income under paragraph 4, the resident is entitled to all benefits of the Convention insofar as they affect the taxation of that item of income in the State of source.

The application of the substantiality test only to income from related parties focuses only on potential abuse cases, and does not hamper certain other kinds of nonabusive activities, even though the income recipient resident in a Contracting State may be very small in relation to the entity generating income in the other. Contracting State. For example, if a small U.S. research firm develops a process that it license to a very large, unrelated, Netherlands pharmaceutical manufacturer, the size of the U.S. research firm would not have to be tested against the size of the Netherlands manufacturer. Similarly, a small U.S. bank that makes a loan to a very large unrelated Netherlands business would not have to pass a substantiality test to receive treaty benefits under Paragraph 4.

Subparagraph (c) of paragraph 4 provides special rules for determining whether a resident of a Contracting State is engaged in the active conduct of a trade or business within the meaning of subparagraph (a). Subparagraph (c) attributes the activities of a partnership to each of its partners. Subparagraph (c) also attributes to a person activities conducted by persons "connected" to such person. A person ("X") is connected to another person ("Y") if X possesses 50 percent or more of the beneficial interest in Y (or if Y possesses 50 percent or more of the beneficial interest in X). For this purpose, X is connected to a company if X owns shares representing fifty percent or more of the aggregate voting power and value of the company or fifty percent or more of the beneficial equity interest in the company. X also is connected to Y if a third person possesses fifty percent or more of the beneficial interest in both X and Y. For this purpose, if X or Y is a company, the threshold relationship with respect to such company or companies is fifty percent or more of the aggregate voting power and value or fifty percent or more of the beneficial equity interest. Finally, X is connected to Y if, based upon all the facts and circumstances, X controls Y, Y controls X, or X and Y are controlled by the same person or persons.

Paragraph 5

Paragraph 5 provides that a resident of one of the Contracting States is entitled to all the benefits of the Convention if that person functions as a recognized headquarters company for a multinational corporate group. For this purpose, the multinational corporate group includes all corporations that the headquarters company supervises and excludes affiliated corporations not supervised by the headquarters company. The headquarters company does not have to own shares in the companies that it supervises. In order to be considered a headquarters company, the person must meet several requirements that are enumerated in Paragraph 5. These requirements are discussed below.

Overall Supervision and Administration

Subparagraph (a) provides that the person must provide a substantial portion of the overall supervision and administration of the group. This activity may include group financing, but group financing may not be the principal activity of the person functioning as the headquarters company. A person only will be considered to engage in supervision and administration if it engages in a number of the following activities: group financing, pricing, marketing, internal auditing, internal communications, and management. Other activities also could be part of the function of supervision and administration.

In determining whether a "substantial portion" of the overall supervision and administration of the group is provided by the headquarters company, its headquarters-related activities must be substantial in relation to the same activities for the same group performed by other entities.

Subparagraph (a) does not require that the group that is supervised include persons in the other State. However, it is anticipated that in most cases the group will include such persons, due to the requirement discussed below that the income derived by the headquarters company be derived in connection with or be incidental to an active trade or business supervised by the headquarters company.

Active Trade or Business

Subparagraph (b) is the first of several requirements intended to ensure that the relevant group is truly "multinational." This sub-paragraph provides that the corporate group supervised by the headquarters company must consist of corporations resident in, and engaged in active trades or businesses in, at least five countries. Furthermore, at least five countries must contribute substantially to the income generated by the group, as the rule requires that the business activities carried on in each of the five countries (or groupings of countries) generate at least 10 percent of the gross income of the group. For purposes of the 10 percent gross income requirement, the income from multiple countries may be aggregated, as long as there are at least five individual countries or groupings that each satisfy the 10 percent

requirement. If the gross income requirement under this clause is not met for a taxable year, the taxpayer may satisfy this requirement by averaging the ratios for the four years preceding the taxable year.

Example. DHQ is a corporation resident in the Netherlands. DHQ functions as a headquarters company for a group of companies. These companies are resident in the United States, Canada, New Zealand, the United Kingdom, Malaysia, the Philippines, Singapore, and Indonesia. The gross income generated by each of these companies for 2004 and 2005 is as follows:

Gross Income Generated in Example

Country	2004	2005
United States	$40	$45
Canada	25	15
New Zealand	10	20
United Kingdom	30	35
Malaysia	10	12
Philippines	7	10
Singapore	10	8
Indonesia	5	10
Total	**$137**	**$155**

For 2004, 10 percent of the gross income of this group is equal to $13.70. Only the United States, Canada, and the United Kingdom satisfy this requirement for that year. The other companies in the group may be aggregated to meet this requirement. Because New Zealand and Malaysia have a total gross income of $20, and the Philippines, Singapore, and Indonesia have a total gross income of $22, these two groupings of countries may be treated as the fourth and fifth members of the group for purposes of clause (2)(h)(ii).

In the following year, 10 percent of the gross income is $15.50. Only the United States, New Zealand, and the United Kingdom satisfy this requirement. Because Canada and Malaysia have a total gross income of $27, and the Philippines, Singapore, and Indonesia have a total gross income of $28, these two groupings of countries may be treated as the fourth and fifth members of the group for purposes of clause (2)(h)(ii). The fact that Canada replaced New Zealand in a group not relevant for this purpose. The composition of the grouping may change from year to year.

Single Country Limitation

Subparagraph (c) provides that the business activities carried on in any one country other than the headquarters company's state of residence must generate less than 50 percent of the gross income of the group. If the gross income requirement under this clause is not met for a taxable year, the taxpayer may satisfy this requirement by averaging the ratios for the four years preceding the taxable year. The following example illustrates the application of this subparagraph.

Example. DHQ is a corporation resident in the Netherlands. DHQ functions as a headquarters company for a group of companies. DHQ derives dividend income from a United States subsidiary in the 2004 taxable year. The state of residence of each of these companies, the situs of their activities and the amounts of gross income attributable to each for the years 2004 through 2008 are set forth below.

State of Residence, Situs of Activities, and Gross Income Attributable to Companies in Example

Company	Situs	2008	2007	2006	2005	2004
United States	U.S.	$100	$100	$95	$90	$85
United States	Mexico	10	8	5	0	0
United States	Canada	20	18	16	15	12
United Kingdom	UK	30	32	30	28	27
New Zealand	N.Z.	40	42	38	36	35
Japan	Japan	35	32	30	30	28
Singapore	Singapore	25	25	24	22	20
Totals		**$260**	**$257**	**$238**	**$221**	**$207**

Because the United States' total gross income of $130 in 2008 is not less than 50 percent of the gross income of the group, clause (2)(h)(iii) is not satisfied with respect to dividends derived in 2008. However, the United States' average gross income for the preceding four years may be used in lieu of the preceding year's average. The United States' average gross income for the years 2004–07 is $111.00 ($444/4). The group's total average gross income for these years is $230.75 ($923/4). Because $111.00 represents 48.1 percent of the group's average gross income for the years 2004 through 2007, the requirement under subparagraph (c) is satisfied.

Other State Gross Income Limitation

Subparagraph (d) provides that no more than 25 percent of the headquarters company's gross income may be derived from the other Contracting State. Thus, if the headquarters company's gross income for the taxable year is $200, no more than $50 of this amount may be derived from the other Contracting State. If the gross income requirement under this clause is not met for a taxable year, the taxpayer may satisfy this requirement by averaging the ratios for the four years preceding the taxable year.

Independent Discretionary Authority

Subparagraph (e) requires that the headquarters company have and exercise independent discretionary authority to carry out the functions referred to in subparagraph (a). Thus, if the headquarters company was nominally responsible for group financing, pricing, marketing and other management functions, but merely implemented instructions received from another entity, the headquarters company would not be considered to have and exercise independent discretionary authority with respect to these functions. This determination is made individually for each function. For instance, a headquarters company could be nominally responsible for group financing, pricing, marketing and internal auditing functions, but another entity could be actually directing the headquarters company as to the group financing function. In such a case, the headquarters company would not be deemed to have independent discretionary authority for group financing, but it might have such authority for the other functions. Functions for which the headquarters company does not have and exercise independent discretionary authority are considered to be conducted by an entity other than the headquarters company for purposes of subparagraph (a).

Income Taxation Rules

Subparagraph (f) requires that the headquarters company be subject to the generally applicable income taxation rules in its country of residence. This reference should be understood to mean that the company must be subject to the income taxation rules to which a company engaged in the active conduct of a trade or business would be subject. Thus, if one of the Contracting States has or introduces special taxation legislation that impose a lower rate of income tax on headquarters companies than is imposed on companies engaged in the active conduct of a trade or business, or provides for an artificially low taxable base for such companies, a headquarters company subject to these rules is not entitled to the benefits of the Convention under Paragraph 5.

In Connection With or Incidental to Trade or Business

Subparagraph (g) requires that the income derived in the other Contracting State be derived in connection with or be incidental to the active business activities referred to in subparagraph (b). This determination is made under the principles set forth in paragraph 4. For instance, if a Netherlands company that satisfied the other requirements in Paragraph 5 acted as a headquarters company for a group that included a United States corporation, and the group was engaged in the design and manufacture of computer software, but the U.S. company was also engaged in the design and manufacture of photocopying machines, the income that the Netherlands company derived from the United States would have to be derived in connection with or be incidental to the income generated by the computer business in order to be entitled to the benefits of the Convention under Paragraph 5. Interest income received from the U.S. company also would be entitled to the benefits of the Convention under this paragraph as long as the interest was attributable to a trade or business supervised by the headquarters company. Interest income derived from an unrelated party would normally not, however, satisfy the requirements of this clause.

Paragraph 6

Paragraph 6 provides that a resident of one of the States that derives income from the other State described in Article 8 (Shipping and Air Transport) and that is not entitled to the benefits of the Convention under paragraphs 1 through 5, shall nonetheless be entitled to the benefits of the Convention with respect to income described in Article 8 if it meets one of two tests.

First, a resident of one of the States will be entitled to the benefits of the Convention with respect to income described in Article 8 if at least 50 percent of the beneficial interest in the person (in the case of a company, at least 50 percent of the aggregate vote and value of the stock of the company) is owned, directly or indirectly, by qualified persons or individuals who are residents of a third state that grants by law, common agreement, or convention an exemption under similar terms for profits as mentioned in Article 8 to citizens and corporations of the other State. This provision is analogous to the relief provided under Code section 883(c)(1).

Alternatively, a resident of one of the States will be entitled to the benefits of the Convention with respect to income described in Article 8 if at least 50 percent of the beneficial interest in the person (in the case of a company, at least 50 percent of the aggregate vote and value of the stock of the company) is owned directly or indirectly by a company or combination of companies the stock of which is primarily and regularly traded on an established securities market in a third state, provided that the third state grants by law, common agreement or convention an exemption under similar terms for profits as mentioned in Article 8 to citizens and corporations of the other State. This provision is analogous to the relief provided under Code section 883(c)(3). The term "primarily and regularly traded on an established securities market" is not defined in the Convention. In determining whether a resident of the Netherlands is entitled to benefits of the Convention under this paragraph, the United States will apply the principles of Code Section 883(c)(3)(A).

A resident of a Contracting State that derives income from the other State described in Article 8 (Shipping and Air Transport) but that does not meet all the requirements of paragraph 5 will nevertheless qualify for treaty benefits if it meets the requirements of any other test under Article 26 (i.e., the publicly-traded test under paragraph 2(c) or the active trade or business test of paragraph 4).

Paragraph 7

Paragraph 7 provides that a resident of one of the States that is not entitled to the benefits of the Convention as a result of paragraphs 1 through 6 still may be granted benefits under the Convention at the discretion of the competent authority of the State from which benefits are claimed. In making determinations under paragraph 7, that competent authority will take into account as its guideline whether the establishment, acquisition, or maintenance of the person seeking benefits under the Convention, or the conduct of such person's operations, has or had as one of its principal purposes the obtaining of benefits under the Convention. Thus, persons that establish operations in one of the States with a principal purpose of obtaining the benefits of the Convention ordinarily will not be granted relief under paragraph, 7.

The competent authority may determine to grant all benefits of the Convention, or it may determine to grant only certain benefits. For instance, it may determine to grant benefits only with respect to a particular item of income in a manner similar to paragraph 3. Further, the competent authority may set time limits on the duration of any relief granted.

For purposes of implementing paragraph 7, a taxpayer will be permitted to present his case to the relevant competent authority for an advance determination based on the facts. In these circumstances, it is also expected that if the competent authority determines that benefits are to be allowed, they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later.

A competent authority is required by paragraph 7 to consult the other competent authority before denying benefits under this paragraph. Subparagraph (b) of Paragraph XXIV of the Understanding includes two provisions intended to ensure that taxpayers receive determinations in a timely manner. First, the competent authorities agree to use reasonable efforts to make a determination pursuant to this paragraph within six months of receiving all of the necessary information from taxpayers. Second, they will meet semi-annually to discuss the status of outstanding cases.

According to paragraph XXVIII of the Understanding, the competent authorities will consider the obligations of the Netherlands by virtue of its membership in the European Communities in making a determination under paragraph 7. In particular, the competent authorities will consider any legal requirements for the facilitation of the free movement of capital and persons, together with the differing internal tax systems, tax incentive regimes and existing tax treaty policies among Member States of the European Communities. As a result, where certain changes in circumstances otherwise might cause a person to cease to be a qualified person under paragraphs 2 and 3 of Article 26, such changes need not result in the denial of benefits.

The changes in circumstances contemplated include, all under ordinary business conditions, a change in the State of residence of a major shareholder of a company; the sale of part of the stock of a Netherlands company to a resident in another Member State of the European Communities; or an expansion of a company's activities in other Member States of the European Communities. So long as the relevant competent authority is satisfied that those changed circumstances are not attributable to tax avoidance motives, they will count as a factor favoring the granting of benefits under paragraph 7, if consistent with existing treaty policies, such as the need for effective exchange of information. See the Technical Explanation to paragraph 3 of Article 10 for a discussion of the factors that the competent authority will consider in making these determinations. A company that wishes the relevant competent authority to take such legal requirements into account must request an advance determination, as described above.

Paragraph 8

Paragraph 8 defines several key terms for purposes of Article 26. Each of the defined terms is discussed in the context in which it is used.

ARTICLE 8

Article 8 restates Article 32 (Limitation of Articles 30 and 31) of' the Convention to make it consistent with the U.S. Model Tax Convention and international norms regarding information exchange and bank secrecy.

Paragraph 1

Paragraph 1 provides that the obligations undertaken in Articles 30 and 31 to exchange information do not require a Contracting State to carry out administrative measures that are at variance with the laws or administrative practice of either State. Moreover, a Contracting State is not required to supply information not obtainable under the laws or administrative practice of either State, or to disclose trade secrets or other information, the disclosure of which would be contrary to public policy. Thus, a requesting State may be denied information from the other State if the information would be obtained pursuant to procedures or measures that are broader than those available in the requesting State. Paragraph VIII confirms that the competent authorities will work together to ensure that the information to be provided will be in a form that facilitates its use in judicial proceedings in the requesting State.

Paragraph 2

In paragraph 2, each Contracting State has confirmed that it will obtain and exchange certain information, notwithstanding the provisions of paragraph 1. The information that may be exchanged includes information held by financial institutions, nominees, or persons acting in an agency or fiduciary capacity. The Contracting States may also obtain and exchange information relating to the ownership

of legal persons and, as described in paragraph XXXVI of the Understanding, will use all reasonable efforts to do so unless obtaining such information gives rise to disproportionate difficulties.

Paragraph 3

Paragraph 3 confirms that the obligation to provide information held by persons acting in a fiduciary capacity does not extend to information that would reveal confidential communications between a client and an attorney, solicitor or other legal representative, where the client seeks legal advice or produced for the purposes of use in existing or contemplated legal proceedings. In the case of the United States, the scope of the privilege for such confidential communications is coextensive with the attorney-client privilege under U.S. law.

ARTICLE 9

Article 9 updates several references in the Convention that have become outdated. Paragraph (a) updates the reference to the Netherlands Mining Act, which consolidated and restated the provisions of the Mining Act of 1810 and the Continental Shelf Mining Act of 1965. Paragraph (b) takes account of the fact that the euro has replaced Netherlands guilders as the currency of the Netherlands.

ARTICLE 10

Article 10 contains the rules for bringing the Protocol into force and giving effect to its provisions.

Paragraph 1 provides for the ratification of the Convention by both Contracting States according to their constitutional and statutory requirements. Each State must notify the other as soon as its requirements for ratification have been complied with. The Convention will enter into force on the date of the later of such notifications.

In the United States, the process leading to ratification and entry into force is as follows: Once a protocol or treaty has been signed by authorized representatives of the two Contracting States, the Department of State sends the protocol or treaty to the President who formally transmits it to the Senate for its advice and consent to ratification, which requires approval by two-thirds of the Senators present and voting. Prior to this vote, however, it generally has been the practice of the Senate Committee on Foreign Relations to hold hearings on the protocol or treaty and make a recommendation regarding its approval to the full Senate. Both Government and private sector witnesses may testify at these hearings. After receiving the Senate's advice and consent to ratification, the protocol or treaty is returned to the President for his signature on the ratification document. The President's signature on the document completes the process in the United States.

The date on which a treaty enters into force is not necessarily the date on which its provisions take effect. Paragraph 1 also contains rules that determine when the provisions of the treaty will have effect.

Under subparagraph (a), the provisions of the Protocol relating to taxes withheld at source will have effect with respect to amounts paid or credited on or after the first day of the second month, following the date on which the Protocol enters into force. For example, if instruments of ratification are exchanged on April 25 of a given year, the withholding rates specified in paragraphs 2 and 3 of Article 10 (Dividends) as provided in Article 3 would be applicable to any dividends paid or credited on or after June 1 of that year. Similarly, the revised Limitation on Benefits provisions of Article 7 would apply with respect to any payments of interest, royalties or other amounts on which withholding would apply under the Internal Revenue Code if those amounts are paid or credited on or after June 1.

This rule allows the benefits of the withholding reductions to be put into effect as soon as possible, without waiting until the fallowing year. The delay of one to two months is required to allow sufficient time for withholding agents to be informed about the change in withholding rates. If for some reason a withholding agent withholds at a higher rate than that provided by the Convention (perhaps because it was not able to re-program its computers before the payment is made), a beneficial owner of the income that is a resident of the Netherlands may make a claim for refund pursuant to section 1464 of the Code.

For all other taxes, subparagraph (b) specifies that the Protocol will have effect for any taxable period beginning on or after January 1 of the year following entry into force.

As in many recent U.S. treaties, paragraph 2 provides an exception to the general rules of paragraph 1 regarding entry into force. Under paragraph 2, if any person

who was entitled to the benefits of the Convention, before modification by the Protocol, would have received greater relief from tax than under the Convention as modified by the Protocol, the Convention as unmodified shall, at the election of any person that was entitled to benefits under the prior Convention, continue to have effect in its entirety for a twelve-month period from the date on which this Convention otherwise would have had effect with respect to such person.

Thus, a taxpayer may elect to extend the benefits of the unmodified Convention for one year from the date on which the relevant provision of the modified Convention would first take effect. During the period in which tie election is in effect, the provisions of the unmodified Convention will continue to apply only insofar as they applied before the entry into force of the Protocol. If the grace period is elected, all of the provisions of the Convention as unmodified must be applied for that additional year. The taxpayer may not apply certain, more favorable provisions of the unmodified Convention and, at the same time, apply other, more favorable provisions of modified Convention. The taxpayer must choose one regime or fir other.

DEPARTMENT OF THE TREASURY TECHNICAL EXPLANATION OF THE SECOND PROTOCOL SIGNED ON JULY 14, 2004, AMENDING THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND BARBADOS FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, SIGNED ON DECEMBER 31, 1984

This is a technical explanation of the Second Protocol signed at Washington on July 14, 2004 (the "Protocol"), amending the Convention between the United States of America and Barbados for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, signed at Bridgetown on December 31, 1984 (the "1984 Convention"), as amended by a protocol signed at Washington, D.C. on December 18, 1991 (the "1991 Protocol"). The term "Convention" refers to the 1984 Convention as modified by both the 1991 Protocol and the Protocol.

Negotiations took into account the U.S. Treasury Department's current tax treaty policy and the Treasury Department's Model Income Tax Convention, published on September 20, 1996 (the "U.S. Model"). Negotiations also took into account the Model Tax Convention on Income and on Capital, published by the Organization for Economic Cooperation and Development, as updated in January 2003 (the "OECD Model"), and recent tax treaties concluded by both countries.

The Protocol was accompanied by Understandings (the "Understandings"), implemented through an exchange of notes, indicating the views of the negotiators and of the States with respect to Article 22 (Limitation on Benefits) of the Convention. The Understandings also provided that the Understandings accompanying the 1991 Protocol (the "1991 Understandings") continue to apply for purposes of applying Article 22 of the Convention, except to the extent that the 1991 Understandings are inconsistent with the provisions of Article 22 (as amended by the Protocol). The Understandings and the 1991 Understandings are discussed in connection with the relevant portions of the Protocol.

The Technical Explanation is an official guide to the Protocol. It reflects the policies behind particular Protocol provisions, as well as understandings reached with respect to the application and interpretation of the Protocol. This Technical Explanation should be read together with the Technical Explanations of the 1984 Convention and the 1991 Protocol.

References in the Technical Explanation to "he" or "his" should be read to mean "he or she" or "his or her."

ARTICLE I

Article I of the Protocol modifies paragraph 3 of Article 1 of the Convention which permits the United States to continue to tax as U.S. citizens former citizens whose loss of citizenship had as one of its principal purposes the avoidance of tax. To reflect 1996 amendments to U.S. tax law in this area, the Protocol extends this treatment to former long-term residents whose loss of such status had as one of its principal purposes the avoidance of tax.

Section 877 of the Internal Revenue Code of 1986 (the "Code") applies to former citizens and long-term residents of the United States whose loss of citizenship or long-term resident status had as one of its principal purposes the avoidance of tax. Under section 877, the United States generally treats an individual as having a principal purpose to avoid tax if either of the following criteria exceed established thresholds: (a) the average annual net income tax of such individual for the period of 5 taxable years ending before the date of the loss of status, or (b) the net worth of such individual as of the date of the loss of status. The thresholds are adjusted annually for inflation. Section 877(c) provides certain exceptions to these presumptions of tax avoidance. The United States defines "long-term resident" as an individual (other than a U.S. citizen) who is a lawful permanent resident of the United States in at least 8 of the prior 15 taxable years. An individual is not treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country and the individual does not waive the benefits of such treaty applicable to residents of the foreign country.

ARTICLE II

Article II of the Protocol replaces Article 22 (Limitation on Benefits) of the Convention.

Structure of the Article

Article 22 follows the form used in other recent U.S. income tax treaties. Paragraph 1 states the general rule that a resident of a Contracting State is entitled to benefits otherwise accorded to residents only to the extent that the resident satisfies the requirements of the Article and any other specified conditions for the obtaining of such benefits and lists a series of attributes of a resident of a Contracting State, any one of which suffices to make such resident entitled to all the benefits of the Convention. Paragraph 2 sets forth the active trade or business test, under which a person not entitled to benefits under paragraph 1 may nonetheless be granted benefits with regard to certain types of income. Paragraph 3 provides that benefits also may be granted if the competent authority of the State from which the income arises determines that it is appropriate to grant benefits in that case. Paragraph 4 defines what constitutes a recognized stock exchange for purposes of paragraph I. Paragraph 5 authorizes the competent authorities to develop agreed applications of the Article and to exchange information necessary for carrying out the provisions of the Article. Paragraph 6 excludes certain persons that are residents and that otherwise would qualify for the benefits of the Convention under paragraphs 1 or 2 of this Article from the benefits of Articles 10 (Dividends), 11 (Interest) and 12 (Royalties).

Article 22 and the anti-abuse provisions of domestic law complement each other, as Article 22 effectively determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while domestic anti-abuse provisions (*e.g.*, business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance. Thus, internal law principles of the source Contracting State may be applied to identify the beneficial owner of an item of income, and Article 22 then will be applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income.

Paragraph 1

Paragraph 1 provides that, except as otherwise provided, a resident of a Contracting State will be entitled to all the benefits of the Convention otherwise accorded to residents of a Contracting State only if the resident is described in one of the subparagraphs of that paragraph 1.

The benefits otherwise accorded to residents under the Convention include all limitations on source-based taxation under Articles 6 through 21, the treaty-based relief from double taxation provided by Article 23 (Relief from Double Taxation), and the protection afforded to residents of a Contracting State under Article 24 (Non-Discrimination). Some provisions do not require that a person be a resident in order to enjoy the benefits of those provisions. Article 25 (Mutual Agreement Procedure) is not limited to residents of the Contracting States, and Article 27 (Diplomatic Agents and Consular Officers) applies to diplomatic agents or consular officials regardless of residence. Article 22 accordingly does not limit the availability of treaty benefits under these provisions.

Paragraph 1 has six subparagraphs, each of which describes a category of residents that are entitled to all benefits of the Convention. It is intended that the provisions of paragraph 1 will be self-executing. Claiming benefits under paragraph 1 does not require advance competent authority ruling or approval. The tax authorities may, of course, on review, determine that the taxpayer has improperly interpreted the paragraph and is not entitled to the benefits claimed.

Individuals—Subparagraph 1(a)

Subparagraph (a) provides that individual residents of a Contracting State will be entitled to all the benefits of the Convention. If such an individual receives income as a nominee on behalf of a third country resident, benefits may be denied under the applicable articles of the Convention by the requirement that the beneficial owner of the income be a resident of a Contracting State.

Governments—Subparagraph 1(b)

Subparagraph (b) provides that the Contracting States and any political subdivision or local authority thereof will be entitled to all the benefits of the Convention.

Publicly-Traded Corporations—Subparagraph 1(c)

Subparagraph (c) applies to two categories of companies: publicly traded companies and subsidiaries of publicly traded companies. A company resident in a Contracting State is entitled to all the benefits of the Convention under clause (i) of subparagraph (c) if its principal class of shares is: (a) listed on a recognized stock exchange located in the Contracting State of which the company is a resident; (b)

primarily traded on a recognized stock exchange located in the Contracting State of which the company is a resident; and (c) regularly traded on one or more recognized stock exchanges. In the case of a company that is resident in Barbados, the company alternatively may satisfy the second requirement if it is primarily traded on either the Jamaica Stock Exchange or the Trinidad Stock Exchange, each of which is a recognized stock exchange, as discussed below.

The term "recognized stock exchange" is defined in paragraph 4. It includes the NASDAQ System and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934, as well as the Barbados Stock Exchange, the Jamaica Stock Exchange and the Trinidad Stock Exchange . The term also includes any other stock exchange agreed upon by the competent authorities of the Contracting States.

The term "principal class of shares" is not defined in the Convention. In accordance with paragraph 2 of Article 3 (General Definitions), this term will have the meaning it has under the laws of the State concerning the taxes to which the Convention applies, generally the source State. Generally, under U.S. tax law, the "principal class of shares" is defined as the common shares of the company representing the majority of the aggregate voting power and value of the company. If the company does not have a class of ordinary or common shares representing the majority of the aggregate voting power and value of the company, then the "principal class of shares" is that class or any combination of classes of shares that represents, in the aggregate, a majority of the voting power and value of the company. "Shares" include depository receipts for shares or trust certificates for shares.

The term "primarily traded" is not defined in the Convention. In accordance with paragraph 2 of Article 3 (General Definitions), this term will have the meaning it has under the laws of the State concerning the taxes to which the Convention applies, generally the source State. In the case of the United States, this term is understood to have the meaning it has under Treas. Reg. section 1.884–5(d)(3), relating to the branch tax provisions of the Code. Accordingly, stock of a corporation is "primarily traded" on a recognized stock exchange in the Contracting State of which the company is a resident if the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in that Contracting State exceeds the number of shares in the company's principal class of shares that are traded during that year on established securities markets in any other single foreign country.

The term "regularly traded" is not defined in the Convention. In accordance with paragraph 2 of Article 3 (General Definitions), this term will have the meaning it has under the laws of the State concerning the taxes to which the Convention applies, generally the source State. In the case of the United States, this term is understood to have the meaning it has under Treas. Reg. section 1.884–5(d)(4)(i)(B), relating to the branch tax provisions of the Code. Under these regulations, a class of shares is considered to be "regularly traded" if two requirements are met: trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. Treas. Reg. section 1.884–5(d)(4)(i)(A), (ii) and (iii) will not be taken into account for purposes of defining the term "regularly traded" under the Convention.

The regular trading requirement can be met by trading on any recognized exchange or exchanges. Trading on one or more recognized stock exchanges may be aggregated for purposes of this requirement. Authorized but unissued shares are not considered for purposes of this test.

A company resident in a Contracting State is entitled to all the benefits of the Convention under clause (ii) of subparagraph (c) of paragraph 1 if: (a) at least 50 percent of the company's principal class of shares is owned directly or indirectly by companies that are publicly traded as provided above; and (b) the company satisfies the requirements of the base erosion clause of paragraph 1(d) of this Article. Furthermore, in the case of indirect ownership, each intermediate owner must be a person entitled to benefits of the Convention under this clause (ii). Thus, for example, a Barbados company, all the shares of which are owned by another Barbados company, would qualify for benefits under the Convention if the principal class of shares of the Barbados parent company were listed on the Barbados Stock Exchange, primarily traded on the Barbados Stock Exchange and regularly traded on the Barbados Stock Exchange and the New York Stock Exchange.

Ownership/Base Erosion—Subparagraph 1(d)

Subparagraph 1(d) provides an additional test that applies to any form of legal entity that is a resident of a Contracting State. The test provided in subparagraph (d), the so-called ownership and base erosion test, is a two-part test. Both prongs of the test must be satisfied for the resident to be entitled to benefits under subparagraph 1(d).

The ownership prong of the test, under clause (i), requires that more than 50 percent of the beneficial interest in that person (or in the case of a company, more than 50 percent of the number of shares of each class of whose shares) is owned, directly or indirectly, on at least half the days of the taxable year by residents of that State that are entitled to the benefits of this Convention under subparagraphs (a), (b), (c)(i), (e) or (f) (other than a person described in paragraph 6 of this Article). Furthermore, in the case of indirect ownership, each intermediate owner must be a resident of that Contracting State.

Trusts may be entitled to benefits under this provision if they are treated as residents under Article 4 (Resident) and they otherwise satisfy the requirements of this subparagraph. For purposes of this subparagraph, the beneficial interests in a trust will be considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust. The interest of a remainder beneficiary will be equal to 100 percent less the aggregate percentages held by income beneficiaries. A beneficiary's interest in a trust will not be considered to be owned by a person entitled to benefits under the other provisions of paragraph 1 if it is not possible to determine the beneficiary's actuarial interest. Consequently, if it is not possible to determine the actuarial interest of any beneficiaries in a trust, the ownership test under clause (i) cannot be satisfied, unless all possible beneficiaries are persons entitled to benefits under the other subparagraphs of paragraph 1.

The base erosion prong of clause (ii) of subparagraph (d) disqualifies a person if 50 percent or more of the person's gross income for the taxable. year is paid or accrued, directly or indirectly, to persons who are not residents of that same Contracting State entitled to the benefits of this Convention under subparagraphs (a), (b), (c)(i), (e) or (f) (other than a person described in paragraph 6 of this Article) in the form of payments that are deductible for the purposes of the taxes covered by this Convention in the State of which the person is a resident. The term "gross income" is not defined in the Convention. Thus, in accordance with paragraph (2) of Article 3 (General Definitions), in determining whether a person deriving income from United States sources is entitled to the benefits of the Convention, the United States will ascribe the meaning to the term that it has in the United States. In the case of the United States, the term "gross income" has the same meaning as such term in section 61 of the Code and the regulations thereunder.

To the extent they are deductible from the taxable base, trust distributions are deductible payments. However, depreciation and amortization deductions, which do not represent payments or accruals to other persons, are disregarded for this purpose. Deductible payments also do not include arm's length payments in the ordinary course of business for services or tangible property.

Tax Exempt Organizations—Subparagraph 1(e)

A tax-exempt organization other than an exempt pension trust is entitled to all the benefits of the Convention, without regard to the residence of its beneficiaries or members. Entities qualifying under this subparagraph are those that are organized and operated exclusively for religious, charitable, scientific, literary or educational purposes and that, by virtue of that status, are generally exempt from income taxation in their Contracting State of residence.

Exempt Employee Benefits Organizations—Subparagraph 1(f)

A plan, scheme, fund, trust, company or other arrangement established in a Contracting State that is operated exclusively to administer or provide employee benefits and that, by reason of its nature as such, is generally exempt from income taxation in that State is entitled to all the benefits of the Convention if more than half of the beneficiaries, members or participants, if any, in such organization are persons that are entitled, under this Article, to the benefits of this Convention. For purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the entity.

Paragraph 2

Paragraph 2 sets forth a test under which a resident of a Contracting State that is not entitled to all benefits of the Convention may receive treaty benefits with re-

spect to certain items of income that are connected to an active trade or business conducted in its State of residence.

Subparagraph (a) sets forth the general rule that a resident of a Contracting State engaged in the active conduct of a trade or business in that State may obtain the benefits of the Convention with respect to an item of income derived in the other Contracting State. The item of income, however, must be derived in connection with or incidental to that trade or business.

The term "active trade or business" is defined in clause (iii) of subparagraph 2(d). In general, a trade or business comprises activities that constitute (or could constitute) an independent economic enterprise carried on for profit. To constitute a trade or business, the activities conducted by the resident ordinarily must include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit. The determination of whether the activities of a resident of a Contracting State constitute an active trade or business is determined under all the facts and circumstances. A resident of a Contracting State actively conducts a trade or business if it regularly performs active and substantial management and operational functions through its own officers or staff of employees. In this regard, one or more of such activities may be carried out by independent contractors under the direct control of the resident. However, in determining whether the corporation actively conducts a trade or business, the activities of independent contractors shall be disregarded.

The business of making or managing investments for the resident's own account will be considered to be a trade or business only when part of banking or insurance activities conducted by a bank or an insurance company. Such activities conducted by a person other than a bank or an insurance company will not be considered to be the conduct of an active trade or business, nor would they be considered to be the conduct of an active trade or business if conducted by a bank or insurance company but not as part of the company's banking or insurance business.

For this purpose, a resident will be treated as a bank only if: (a) it is licensed to accept deposits from residents of the Contracting State of which it is a resident and to conduct, in that State, lending or other banking activities; (b) it regularly accepts deposits from customers who are residents of the Contracting State of which it is a resident in the ordinary course of its business and the amount of deposits shown on the company's balance sheet is substantial; and (c) it regularly makes loans to customers in the ordinary course of its trade or business. Furthermore, a resident will be treated as an insurance company only if: (a) it is licensed to insure risks of residents of the Contracting State of which it is a resident; and (b) it regularly insures (not including reinsurance) risks of customers who are residents of the Contracting State of which it is a resident.

Because a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in an active trade or business for purposes of subparagraph (a).

An item of income is derived in connection with a trade or business if the income-producing activity in the State of source is a line of business that "forms a part of" or is "complementary" to the trade or business conducted in the State of residence by the income recipient. A business activity generally will be considered to form part of a business activity conducted in the State of source if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services. The notes clarify that the line of business in the State of residence may be upstream, downstream, or parallel to the activity conducted in the State of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the State of source, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the State of source.

For two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Where more than one trade or business is conducted in the State of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the State of residence, it is necessary to identify the trade or business to which an item of income is attributable. Royalties generally will be considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends will be deemed to be derived first out of earnings and profits of the treaty-benefited trade or business, and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied.

A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

An item of income derived from the State of source is “incidental to” the trade or business carried on in the State of residence if production of the item facilitates the conduct of the trade or business in the State of residence. An example of incidental income is the temporary investment of working capital of a person in the State of residence in securities issued by persons in the State of source.

Subparagraph (b) of paragraph 2 states a further condition to the general rule in subparagraph (a) in cases where the trade or business generating the item of income in question is carried on either by the person deriving the income or by any associated enterprises. Subparagraph (b) states that the trade or business carried on in the State of residence, under these circumstances, must be substantial in relation to the activity in the State of source. The requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in *de minimis* connected business activities in the treaty country in which it is resident (i.e., activities that have little economic cost or effect with respect to the company business as a whole).

The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each Contracting State (measured by reference to asset values, income and payroll expenses), the nature of the activities performed in each Contracting State, and the relative contributions made to that trade or business in each Contracting State. In any case, in making each determination or comparison, due regard will be given to the relative sizes of the U.S. and Barbados economies.

In addition to this subjective rule, subparagraph (b) provides a safe harbor under which the trade or business of the income recipient may be deemed to be substantial based on three ratios that compare the size of the recipient’s activities to those conducted in the other State with respect to the preceding taxable year, or the average of the preceding three years. The three ratios compare: (i) the value of the assets in the recipient’s State to the assets used in the other State; (ii) the gross income derived in the recipient’s State to the gross income derived in the other State; and (iii) the payroll expense in the recipient’s State to the payroll expense in the other State. The average of the three ratios must exceed 10 percent, and each individual ratio must equal at least 7.5 percent. For purposes of this test, if the income recipient owns, directly or indirectly, less than 100 percent of the activity conducted in either State, only its proportionate share of the activity will be taken into account.

The determination in subparagraph (b) also is made separately for each item of income derived from the State of source. It therefore is possible that a person would be entitled to the benefits of the Convention with respect to one item of income but not with respect to another.

If a resident of a Contracting State is entitled to treaty benefits with respect to a particular item of income under paragraph 2, the resident is entitled to all benefits of the Convention insofar as they affect the taxation of that item of income in the State of source.

The application of the substantiality test only to income from related parties focuses only on potential abuse cases, and does not hamper certain other kinds of non-abusive activities, even though the income recipient resident in a Contracting State may be very small in relation to the entity generating income in the other Contracting State. For example, a small Barbados bank that makes a loan to a very large unrelated U.S. business would not have to pass a substantiality test to receive treaty benefits under Paragraph 2.

As discussed above, paragraph 1 of the Understandings provides that the 1991 Understandings continue to apply for purposes of applying Article 22 of the Convention, except to the extent that the 1991 Understandings are inconsistent with the provision of Article 22 (as amended by the Protocol). In this regard, the 1991 Understandings make clear that this provision is self executing; unlike the provisions of paragraph 3, discussed below, it does not require advance competent authority ruling or approval. The 1991 Understandings contain a number of examples illustrating the intention of the negotiators with respect to the interpretation of the active trade or business provisions in the 1991 Protocol.

Subparagraph (c) of paragraph 2 provides special rules for determining whether a resident of a Contracting State is engaged in the active conduct of a trade or business within the meaning of subparagraph (a). Subparagraph (c) attributes the activities of a partnership to each of its partners, Subparagraph (c) also attributes to a person activities conducted by persons “connected” to such person. A person (“X”) is connected to another person (“Y”) if X possesses 50 percent or more of the beneficial interest in Y (or if Y possesses 50 percent or more of the beneficial interest

in X). For this purpose, X is connected to a company if X owns shares representing 50 percent or more of the aggregate voting power and value of the company or fifty percent or more of the beneficial equity interest in the company. X also is connected to Y if a third person possesses 50 percent or more of the beneficial interest in both X and Y. For this purpose, if X or Y is a company, the threshold relationship with respect to such company or companies is 50 percent or more of the aggregate voting power and value or 50 percent or more of the beneficial equity interest. Finally, X is connected to Y if, based upon all the facts and circumstances, X controls Y, Y controls X, or X and Y are controlled by the same person or persons.

Paragraph 3

Paragraph 3 provides that a person that is not entitled to the benefits of this Convention pursuant to the provisions of paragraph 1 may, nevertheless, be granted the benefits of the Convention at the discretion of the competent authority of the State in which the income in question arises. The paragraph itself provides no guidance to competent authorities or taxpayers as to how the discretionary authority is to be exercised. The 1991 Understandings, which generally continue to apply, as discussed above, provide that, for purposes of implementing paragraph 3, taxpayers will be permitted to present their cases to the competent authority for an advance determination based on the facts, and will not be required to wait until the tax authorities of one of the Contracting States have determined that benefits are denied. In these circumstances, it is also expected that if the competent authority determines that benefits are to be allowed, they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later.

The 1991 Understandings further provide that, in making determinations under paragraph 3, the competent authorities will take into account all relevant facts and circumstances. The factual criteria that the competent authorities are expected to take into account include the existence of a clear business purpose for the structure and location of the income-earning entity in question; the conduct of an active trade or business (as opposed to a mere investment activity) by such entity; and a valid business nexus between that entity and the activity giving rise to the income.

The 1991 Understandings also note that the discretionary authority granted to the competent authorities is particularly important in view of, and should be exercised with particular cognizance of, the developments in, and objectives of, international economic integration, such as that among the member countries of the CARICOM and under the North American Free Trade Agreement.

In this regard, the Understandings provide specific guidance in the case of an employee benefits organization that fails to satisfy the requirements of subparagraph (f) of paragraph 2 solely because 50 percent or less of its beneficiaries, members or participants are persons entitled to the benefits of the Convention. In such case, the U.S. Competent Authority will favorably consider the following factors: (a) the organization is established in Barbados; (b) the sponsoring employer of the organization is a resident of Barbados entitled to the benefits of the Convention (other than a person described in paragraph 6 of Article 22); (c) more than 30 percent of the beneficiaries, members or participants of the organization are persons entitled to the benefits of this Convention; and (d) more than 70 percent of the beneficiaries, members or participants of the organization are individuals resident in a member of the Caribbean Community.

The competent authority may determine to grant all benefits of the Convention, or it may determine to grant only certain benefits. For instance, it may determine to grant benefits only with respect to a particular item of income in a manner similar to paragraph 2. Further, the competent authority may set time limits on the duration of any relief granted.

Paragraph 4

Paragraph 4 defines the term "recognized stock exchange." See the paragraph 1 discussion above.

Paragraph 5

Paragraph 5 of Article 22 authorizes the competent authorities both to develop procedures for the application of the Article, and to exchange information necessary to carry out its provisions. Thus, for example, if a Barbadian resident corporation claims benefits on the basis of having satisfied the ownership/base erosion tests of subparagraph 1(d), the U.S. competent authority may request information from the Barbados competent authority to confirm that these tests have, in fact, been satisfied.

Paragraph 6

Paragraph 6 excludes certain persons that are residents and that otherwise would qualify for the benefits of the Convention under paragraphs 1 or 2 of this Article from the benefits of Articles 10 (Dividends), 11 (Interest) and 12 (Royalties). Paragraph 6 denies these benefits in the case of a person that is entitled to income tax benefits under the provisions of a special tax regime. Paragraph 6 also treats a partnership, estate or trust as a person that is entitled to income tax benefits under the provisions of a special tax regime to the extent that such partnership, estate or trust is treated as a resident of a Contracting State under paragraph 1 of Article 4 (Residence) by reason of income of such partnership, estate or trust being subject to tax in the hands of one or more persons described in paragraph 6.

The Understandings identify several regimes in Barbados that are special tax regimes. These regimes are as follows: (1) the Exempt Insurance Act, Cap. 308; (2) the International Financial Services Act, 2002; (3) the International Business Companies Act, Cap. 77; (4) the Societies with Restricted Liability Act, Cap. 318B; or (5) the Insurance (Miscellaneous Provisions) Act, 1998. The Understandings further provide that any legislation or administrative practice enacted or adopted after the signing of this Protocol pursuant to which the income of a person is entitled to the same or substantially similar tax benefits to those granted under the legislation referred to in the previous sentence will constitute a special regime. In determining whether a person in entitled to the same or substantially similar benefits to those tax regimes identified in the understandings, consideration will be given to all facts and circumstances, including, for example, whether a tax regime imposes tax based on an artificially low taxable base.

ARTICLE III

Article III of the Protocol amends Article 26 (Exchange of Information) of the Convention to add a new paragraph 4. Paragraph 4 makes clear that information exchanged under Article 26 of the Convention includes information held by financial institutions, nominees, or persons acting in an agency or fiduciary capacity (but does not include information that would reveal confidential communications between a client and an attorney, solicitor or other legal representative, where the client seeks legal advice). In the case of the United States, the scope of the privilege for such confidential communications is coextensive with the attorney-client privilege under U.S. law. Paragraph 4 also makes clear that the Contracting States may obtain and exchange information relating to the ownership of legal persons.

ARTICLE IV

Article IV relates to entry into force of the modifications made by the Protocol.

Paragraph 1

Paragraph 1 provides that the Protocol shall be subject to ratification by both Contracting States according to their constitutional and statutory requirements. Instruments of ratification shall be exchanged as soon as possible.

In the United States, the process leading to ratification and entry into force is as follows: once a protocol or treaty has been signed by authorized representatives of the two Contracting States, the Department of State sends the protocol or treaty to the President who formally transmits it to the Senate for its advice and consent to ratification, which requires approval by two-thirds of the Senators present and voting. Prior to this vote, however, it generally has been the practice of the Senate Committee on Foreign Relations to hold hearings on the protocol or treaty and make a recommendation regarding its approval to the full Senate. Both Government and private sector witnesses may testify at these hearings. After receiving the Senate's advice and consent to ratification, the protocol or treaty is returned to the President for his signature on the ratification document. The President's signature on the document completes the process in the United States.

Paragraph 2

Paragraph 2 provides that the Protocol will enter into force upon the exchange of instruments of ratification. The date on which a treaty or protocol enters into force is not necessarily the date on which its provisions take effect. Paragraph 2, therefore, also contains rules that determine when the provisions of the. Protocol will have effect.

Under paragraph 2(a), the Protocol will have effect with respect to taxes withheld at source (principally dividends, interest and royalties) for amounts paid or credited on or after the first day of the second month following the date on which the Pro-

tocol enters into force. For example, if instruments of ratification are exchanged on April 25 of a given year, the availability of benefits under Article 10 (Dividends) of the Convention will be limited under Article 22, as amended by the Protocol, for any dividends paid or credited on or after June 1 of that year. The delay of one to two months is required to allow sufficient time for withholding agents to be informed about the change in withholding rates.

For all other taxes, subparagraph (b) specifies that the Protocol will have effect for any taxable year beginning on or after January 1 of the year following entry into force.

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